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Creating Carryback Financing

3rd Edition

Cutoff Dates:
Legal editing of this material was
completed September 2006
(Updated for material changes as of April 2008)

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Printed in the United States of America

Editorial Staff

Legal Editor/Publisher:
Fred Crane

Managing Editor:
Ai M. Kelley

Project Editor:
Connor P. Wallmark

Contributing Editors:
David F. Crane
Giang Hoang

Comments or suggestions to:
first tuesday, P.O. Box 20069, Riverside, CA 92516

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Carryback disclosure checklist

This is a guide of the disclosure aspects to be considered in a carryback sale transaction.

Notices of Default and Delinquency — The seller should record and serve a Request for Notice of Default (NOD) and Notice of Delinquency (NODq) on all senior lienholders. [See Chapter 5]

Buyer credit checks — Accurate credit information on the buyer helps in the analysis of the risk of default on the carryback note and failure to maintain the property under the trust deed. [See Chapter 4]

Tax service — For an annual fee, a tax service can advise the seller whether the real estate taxes on the secured property have been paid. [See Chapter 3]

Land sales contracts and purchase-lease-options — The seller should use a note and trust deed as the security device for the carryback sale. Other security devices such as land sales contracts and lease-options create misunderstandings, blurring the buyer's and seller's rights in title to the property.

The all-inclusive trust deed — When the seller wraps a senior trust deed with an all-inclusive trust deed (AITD), the seller retains responsibility for the underlying loan, the remaining balance of which is included in the amount of the AITD note. Responsibility for due-on acceleration, prepayment penalties, late charges and future advances is passed on to the buyer. An AITD can provide the seller with an interest rate override and, taxwise, avoids mortgage-over-basis debt relief and year-of-sale taxes. [See Chapter 13, 14 and 15]

Underlying ARM loans — When the seller wraps an adjustable rate mortgage (ARM) with an all-inclusive trust deed (AITD), the interest rate on the AITD should be conformed to the variable rate on the wrapped loan. This allows the seller to pass on to the buyer any increases in the interest rate on the underlying ARM.

Subordination agreements — The seller might agree to subordinate his carryback trust deed to a loan to finance either the purchase price or a construction project. The subordination agreement must provide adequate safeguards regarding the terms of the loan to which the carryback seller will subordinate his carryback trust deed. [See Chapter 16]

Due-on sale restrictions —The carryback seller should negotiate a waiver of the lender's due-on rights contained in the underlying trust deed. [See Chapter 11 and 12]

Co-owners, co-signers and guarantors — When the seller negotiates for third-party promises to pay or acquire the carryback note on a default, a guarantee agreement should be considered.

No downpayment carryback sales —The seller who accepts a carryback note without a cash downpayment must be adequately secured by additional security and guarantees, or he assumes a high risk of loss. [See Chapter 18]

Foreclosure and resale costs — Should the buyer default on the carryback note, in addition to recovery of the cost to foreclose and resell the property, the seller may be unable to recover the total amount of the note due to waste. [See Chapter 20]

Late charge enforcement — Late charges on carryback notes are governed by different rules for different types of property, some permit percentage formulas and others allow only out-of-pocket dollar losses.

Prepayment penalties — Sellers carry back paper to avoid profit taxes until the year the principal on the note is reduced. A prepayment penalty, not a lock-in clause, meets sellers' tax reporting objectives by shifting the amount of taxes due on early payoff to the buyer.

Lock-in clauses — A loan lock-in clause is an unenforceable restraint on an owner's right to refinance his property, except in special circumstances. Enforceable prepayment penalties usually meet the same objective as sought by the use of a lock-in clause.

The secured assumption agreement — A buyer's assumption of existing loans on the property sold may be entered into with the seller, not just the lender, and should be secured by a trust deed carried back on the property. [See **first tuesday** Forms 432 and 441]

Shared appreciation mortgage — A seller can structure his carryback note as a shared appreciation mortgage (SAM) with both a low, fixed-rate interest and an additional contingent interest consisting of a percentage of either the property's future net appreciated value or the note balance. [See Chapter 7]

Usury on modification — A carryback note is not subject to usury law limits on the rate of interest charged.

Partial release of security — A partial release addendum allows a buyer of two or more lots to resell individual lots either free of a blanket carryback trust deed or subject to it. The partial release terms must be fair to the seller and complete in their terms to be enforceable by the buyer.

Sale of the carryback note — A carryback seller, intending to later dispose of the paper for cash or in an exchange, must consider the most marketable loan documentation and prepayment terms negotiable for the note and trust deed. On the sale of the paper, a carryback seller should consider which method of transfer imposes the greatest liability on him should the borrower default. [See Chapter 6]

Collateral assignment — Instead of selling the carryback note, the carryback seller could borrow against it, hypothecating the note and trust deed and triggering the payment of taxes on carryback profits. [See Chapter 22]

Waste and non-recourse notes — If the buyer neglects to maintain the property, resulting in a decrease in its value, the seller may foreclose on an underbid and recover his losses due to waste, even though a deficiency is barred on the carryback note. [See Chapter 10]

Foreclosure: 3 months, 21 days — The carryback seller's trust deed allows him to foreclose on the property by a trustees sale, a quick and efficient method, consuming at least 111 days once the process is started by recording a Notice of Default (NOD). [See Chapter 5]

Carryback tax advantages — The seller automatically reports his profit on the carryback note over several years instead of entirely in the year of sale. However, tax knowledge of imputed rates, debt relief, assignments, all-inclusive trust deed (AITD) collection agents, alternative minimum tax (AMT), unrecaptured gains rate, reporting elections, etc., is required. [See Chapter 22]

Imputed interest rates — If the interest rate charged on the carryback note is less than the note's Applicable Federal Rate (AFR), the seller reports interest income as though he charged the minimum rate. [See Chapter 21]

Profit on repossession — Unlike a money lender, should the carryback seller have to foreclose and take back the property, no profit is reported except for any net proceeds from the down payment or installments not previously taxed. [See Chapter 20]

<u>Introduction</u>

Creating Carryback Financing is part of the **first tuesday** series of California-specific real estate study materials. Each title in the series of advanced study has a different topic as its primary content. As part of a comprehensive real estate education program, the series includes Real Estate Matters; Landlords, Tenants and Property Management; The §1031 Reinvestment Plan; Tax Benefits of Ownership; Buying Homes in Foreclosure; Limited Liability Company for Group Investments; Rights of Ownership and Due Diligence and Disclosures.

first tuesday's real estate series uses plain language and eliminates the extensive overlap of identical course material commonly offered by other educators.

Creating Carryback Financing is written for real estate licensees, attorneys and investors. This course material is designed to be an educational tool for use in the classroom and as a technical research and reference tool.

The objective of this study is to equip brokers, buyers and sellers in carryback financing transactions with the ability to: present the correct, most efficient structuring for a seller's extension of credit to a buyer of real estate; demonstrate the defective and evasive use of unescrowed sales; advise on the financial risks of loss through disclosure forms and notices so steps can be taken to minimize or eliminate the financial risks; analyze the tax deferring permitted by seller financing, and the reporting of profits, return of capital, interest income and losses; and document the seller's cash out of the carryback paper through its sale to investors.

Creating Carryback Financing reviews all ancillary agreements and their applications to the basic carryback note and trust deed, such as due-on waivers, subordination agreements, partial reconveyance addendums, guarantees, other or additional security, late charges/prepayment penalties, and lock-in provisions.

Unless a form cited in the book says, "See Form 150 *accompanying this chapter*" [emphasis added], it is not in the book. Unless the form accompanies the chapter, it is not crucial to your understanding of the copy. However, you can view the form on the Course Materials CD which contains the book, and online on the **first tuesday** Forms Download page.

Additional materials specific to **Creating Carryback Financing** are available online for further research at <u>firsttuesday.us/supplement.cfm</u>.

Chapter 1 Carryback note in lieu of cash

This chapter introduces the concept of carryback financing and presents the various forms of documentation.

Seller financing supports the price

Most real estate sales involve the financing of some portion of the purchase price. During economic periods of plentiful and inexpensive mortgage money, the financing needed to fund the purchase of real estate is provided by an institutional or private lender, or more likely a mortgage banker.

However, when **economic conditions** tighten and reduce the availability of real estate loans to previously qualified buyers, a seller hoping to sell his property and maintain his asking price must consider financing the purchase himself if he is to obtain a buyer.

Seller financing, also called an *installment sale* or *credit sale*, involves carrying back a note for that portion of the price remaining unpaid after the initial down payment. Under most circumstances, the note will be secured by a first or second trust deed on the property being sold.

Thus, the carryback seller takes a secured creditor's position in the property, comparable to that of a mortgage lender. On closing, the legal rights and obligations of real estate ownership are shifted by the transfer to the buyer, while the carryback seller takes on the rights and obligations of a secured creditor.

Carryback financing offers considerable financial and tax advantages for both buyers and sellers of real estate when the installment sales transaction is properly structured. The seller who offers a convenient and flexible financing package to prospective buyers makes his property more marketable and defers the tax bite.

Qualified buyers are willing to pay a higher price for real estate if attractive financing is available, be it provided by the seller or a mortgage lender.

Even the most qualified buyer might agree to a higher price when he can defer payment of the price through financing provided by the seller, especially when the rate of interest on the carryback financing is competitive or below the rates lenders are charging on their purchase-assist loans.

Tax benefits and flexible sales terms

Taxwise, it may be preferable for the seller to carry back a portion of the sales price, rather than be cashed-out on the sale. The seller will be able to defer tax reporting of his profits on the sale, spreading the payment of profit taxes over a period of years and avoiding a premature tax bite on his profit in the year of the sale. [See Chapter 22]

Finally, the seller should understand the tax impact of the interest he receives on carryback financing interest is *portfolio category income*. The seller converts his real estate equity into a note which generates a constant cash flow, rather than being cashed-out of his equity, paying taxes and reinvesting what remains of his diminished sales proceeds after the payment of taxes.

The carryback note typically provides for a higher interest yield than is available on other investments with a similar level of risk. Additionally, the seller has a first hand knowledge of his security.

For buyers, seller carryback financing offers a moderate down payment, competitive interest rates, less stringent terms for qualification than those imposed by lenders and no origination costs.

Mortgage lenders typically require a minimum down payment of 20% for the buyer to avoid the additional burden of qualifying for *private mortgage insurance* (PMI). In a carryback sale, the amount of the down payment is negotiable between the buyer and seller without outside influences, such as the requirements of the secondary mortgage market pools and PMI underwriters, which mortgage brokers and borrowers must contend with.

Also, the buyer is able to negotiate a lower-than-market interest rate in exchange for agreeing to the seller's higher-than- market asking price. However, the seller can have one or the other, but not both, if the buyer (or the buyer's broker) is knowledgeable.

The varieties and variations of carryback financing

Seller financing is documented in a variety of ways, including land sales contracts, lease-option sales, sale-leasebacks and trust deed notes.

Legally, the note and trust deed is the most certain and universally understood of the various documents for structuring seller financing. The **carryback documentation** consists of:

- a **promissory note** executed by the buyer in favor of the seller as evidence that a portion of the price remains to be paid for the real estate; and
- a **trust deed lien** on the property sold to secure the debt owed by the buyer as evidenced by the note.

The promissory note states the exact amount and terms for repayment of the debt the buyer owes to the seller. On the other hand, the trust deed is a lien on the property which acts as security for payment of the debt. The trust deed requires the buyer to maintain the secured property and gives the seller the power to foreclose through a trustee's sale should the buyer default on note payments or trust deed conditions.

The note and trust deed can be structured in regular or all- inclusive terms to meet the needs of the buyer and seller.

For instance, if the real estate is encumbered by a first trust deed which a qualified buyer can **assume** with the lender, the seller can carry back a regular note secured by a second trust deed for the balance of the **seller's equity** which remains unpaid after deducting the buyer's down payment.

However, if the existing loan is not assumable by the buyer, the buyer might arrange a new first trust deed loan to pay off the existing financing. [See Chapter 12]

As with a buyer's assumption of the existing loan, the seller can carry back a regular note for his remaining unpaid equity in the property and a trust deed to secure it, which is junior to the new lender's trust deed.

Another alternative which reduces the seller's risk of loss and defers more profit taxes than a regular second trust deed note, is the all-inclusive trust deed (AITD) note, called a *wraparound security device*. In an AITD carryback arrangement, the seller is secured by a junior trust deed lien on the property. However, the trust deed secures a note for a dollar amount equal to the balance of the entire purchase price remaining unpaid after the down payment, not a regular note limited to the amount of equity remaining unpaid after the down payment. [See Chapter 13]

Thus, the AITD "wraps" the senior financing by including the dollar amount of the first trust deed in the principal amount of the AITD note. The buyer makes payments to the seller on the AITD note. In turn, the seller continues to remain responsible and make payments on the senior loan out of the buyer's payments received on the AITD. [See Chapter 13]

Chapter 2 The carryback purchase agreement

This chapter discusses an agent's considerations when preparing or analyzing a purchase agreement offer containing provisions for a note and trust deed to be carried back by a seller.

Negotiating the terms for seller financing

A buyer contacts a real estate agent to assist him in an effort to locate and purchase real estate. The agent obtains information about the buyer's financial status and general description of the real estate to be located and the terms of its purchase — price and financing — preferred by the buyer.

The buyer is able to make a down payment of $30,000 and is prequalified to originate or assume a loan up to $300,000.

Before the agent begins to locate suitable property, the buyer is presented with a fully prepared **Buyer's Listing Agreement** for signatures. The agent explains he needs the written retainer agreement so other brokers and agents will fully recognize his agency and readily provide information (disclosures) on their listed properties in advance of his buyer making an offer. [See **first tuesday** Form 103]

The buyer enters into the **Buyer's Listing Agreement**, obligating the agent's broker to locate property under an exclusive authorization on behalf of the buyer in exchange for an enforceable fee arrangement. [**Phillippe** v. **Shapell Industries, Inc.** (1987) 43 C3d 1247]

Later, the agent locates a property he believes meets the financial objectives and preferences of the buyer.

The listed sales price for the property is $330,000. After the agent's cursory review of the property's features with the buyer, the buyer indicates he wants more information about the terms and conditions of the transaction as he would like to make an offer. The real estate agent collects all the basic property disclosures from the seller's listing agent so the buyer can make an informed decision regarding the terms and conditions for an offer, if he decides to purchase the property.

After receiving the seller's property disclosures and before discussing the details of the property and the potential purchase with his buyer, the real estate agent prepares a purchase agreement, relying on the buyer's financial condition and expectations reviewed during their prior discussions, called *counseling*. [See Figure 1]

Having considered and prepared the purchase offer he will propose, the agent is ready to discuss with the buyer the merits and reasons for entering into the offer. Together, the buyer and agent will mold the final purchase offer which will be signed and submitted to the seller.

The purchase agreement's financing provisions

Continuing with our previous example, consider the agent who, on investigation, learns the seller received one offer since he listed the property three months ago. It was an all-cash offer for $275,000, calling for the seller to pay all the buyer's nonrecurring financing charges and closing costs. The seller countered at $300,000, calling for the buyer to pay his own costs and charges. The buyer rejected the counter offer and the seller lost the prospective buyer.

The property is encumbered with an existing trust deed loan of $150,000, at a 5.5% fixed rate of interest, payable $916.93 monthly, until paid, with 25 years remaining. The listing agent failed to include the financing in the MLS data on the property, but supplied it on request.

Interest charged on a new loan is currently at a *note rate* of 7.25%, whether fixed or variable. Thus, the difference in payments between the existing loan and a new loan is nearly $2,000 in annual savings, comprised entirely of interest.

The buyer's agent recommends that the buyer offer the seller $300,000, the amount of the seller's counter offer to the previous buyer. The agent informs the buyer of his belief that the cash value of the property is probably less than $280,000, but notes that sellers typically resist trends in weakening prices, causing prices to be "sticky" in deteriorating markets in spite of fewer prospective buyers.

The terms suggested by the agent include savings due to monthly payments and interest rate charges for a new loan, greater loan reduction, and avoidance of new loan costs, as well as reducing the seller's closing costs by avoiding a prepayment penalty on a payoff of his loan. The buyer's savings over the first five years of ownership would be approximately $36,000, which would effectively place a **present worth** on the property of less then a $280,000 cash offer.

The terms proposed by the buyer's agent for payment of the $300,000 price includes:

- a down payment of $30,000 in cash;
- a takeover of the $150,000 existing loan on the property; and
- a note for $120,000 executed by the buyer in favor of the seller, secured by a trust deed carried back on the property.

The terms for payment of the $120,000 carryback note include:

- interest at the note's Applicable Federal Rate of 4.5%;
- a monthly payment of $813.47 (a 17 year, 10 months amortization schedule); and
- a final/balloon payment of $64,583, due ten years after the close of escrow.

Documenting the estimated savings

The agent prepares a worksheet to document the savings of approximately $36,000 the buyer will realize over the first five years of ownership under the proposed carryback transaction, which include:

- $12,916 on the takeover of the existing $150,000 loan at 5.5% versus the current market rate of 7.25% on that amount (both amortized over 25 years), which includes a savings over five years of $9,646 due to the differences in the dollar amount of payments ($916.93 versus $1,077.70, a $160.77 monthly saving), and additional principal reduction over five years of $3,270 ($137,176 at 7.25% versus $133,907 at 5.5%);
- $17,864 on the $120,000 carryback at 4.5% versus current 7.25% market rates (both payable at $813.47 monthly, amortized over 17 years ten months versus 30 years) due solely to the additional principal reduction within five years ($95,390 balance at 4.5% versus $113,254 at 7.25%); and

Figure 1 *Excerpt from Form 150*

TERMS: Buyer to pay the purchase price as follows:

3. Cash payment through escrow, including deposits, in the amount of . . . . $_______________

3.1 Other consideration paid through escrow ________________________________ . . . $_______________

4. Buyer to obtain a ☐ first, or ☐ second, trust deed loan in the amount of . . . . $_______________
payable approximately $_______________ monthly for a period of ______ years.
Interest on closing not to exceed ______%, ☐ ARM, type _______________________.
Loan points not to exceed _____________.

4.1 ☐ Unless Buyer, within ______ days after acceptance, hands Seller satisfactory written confirmation Buyer has been pre-approved for the financing of the purchase price, Seller may terminate the agreement. [See **ft** Form 183]

5. ☐ Take title subject to, or ☐ Assume, an existing first trust deed note held by ____ with an unpaid principal balance of . . . . $_______________
payable $_______________ monthly, including interest not exceeding _____%,
☐ ARM, type _________________________, plus a monthly tax/insurance impound payment of $______________. ____

5.1 At closing, loan balance differences per beneficiary statement(s) to be adjusted into: ☐ cash, ☐ carryback note, or ☐ sales price.

5.2 The impound account to be transferred: ☐ charged, or ☐ without charge, to Buyer.

6. ☐ Take title subject to, or ☐ Assume, an existing second trust deed note held by ____ with an unpaid principal balance of . . . $_______________
payable $_______________ monthly, including interest not exceeding ______%,
☐ ARM, type __________________________, due _____________, 20 ______.

7. Assume a tax bond or assessment lien with an unpaid principal balance of . . . . $_______________

8. Note for the balance of the purchase price in the amount of. . . . . $_______________
to be executed by Buyer in favor of Seller and secured by a trust deed on the property junior to any above referenced financing, payable $_______________ monthly, or more, beginning one month after closing, including interest at ______% per annum from closing, due _______________ years after closing.

8.1 This note and trust deed to contain provisions to be provided by Seller for: ☐ due-on-sale, ☐ prepayment penalty, ☐ late charges, ☐ ______________.

8.2 A Carryback Disclosure Statement is attached as an addendum. [See **ft** Form 300]

8.3 Buyer to provide a Request for Notice of Default and Notice of Delinquency to senior encumbrancers. [See **ft** Form 412]

8.4 Buyer to hand Seller a completed credit application on acceptance. [See **ft** Form 302]

8.5 Within ______ days of receipt of Buyer's credit application, Seller may terminate the agreement based on a reasonable disapproval of Buyer's creditworthiness.

8.6 Seller may terminate the agreement on failure of the agreed terms for priority financing. [See **ft** Form 183]

8.7 As additional security, Buyer to execute a security agreement and file a UCC-1 financing statement on any property transferred by Bill of Sale. [See **ft** Form 436]

9. **Total Purchase Price is** . . . . $_______________

- $5,000 (approximate) savings by avoiding the costs of originating a $270,000 purchase-assist loan with its costs, charges, discounts, fees, points, lender's title policy, etc.

The agent notifies the buyer he added a provision in an addendum to the purchase agreement. The existing trust deed contains a due-on clause as disclosed by the property profile the agent ordered out from the title company since the listing agent had not ordered a copy. On any take over of an existing loan, the lender has the right to call or demand a recast of the terms for payment of the note.

The added provision calls for the seller to enter into a *subordination agreement*, which will be needed by the buyer should the lender call the loan, demand a loan modification or an early payoff. If a payoff is required, the property will need to be refinanced to borrow sufficient funds to pay off the demand on the existing first trust deed and cover the refinancing charges.

Either way, should the lender call the loan or demand a modification, the seller will need to cooperate by entering into a specific **subordination agreement** at the time of the loan modification or recording of the refinancing. To be assured the seller will cooperate, he must sign an agreement agreeing to the future

subordination of the carryback trust deed on a modification or refinance of the first trust deed. [See **first tuesday** Form 281]

Adjustments on closing for any difference between the amount of the balance on the existing loan at closing and as stated in the purchase agreement will be made into the principal amount of the carryback note.No adjustments will be made in the price or downpayment. [See Figure 1 §5.1]

Required financing disclosures

The agent preparing a carryback offer must disclose to both the buyer and seller the various financial and legal features which influence prudent sellers and buyers in a carryback transaction. For offers involving four-or-less residential units, the minimum carryback financing disclosures are **mandated by statute**, others are imposed by case law. [See **first tuesday** Form 180]

A statutory **Carryback Disclosure Statement** on a credit sale of a one-to-four unit residential property is intended to be prepared and attached to the purchase agreement as an addendum. If it is not included with the purchase agreement, a statutory contingency is triggered, giving the buyer the right to cancel the transaction until the disclosure form is signed by the buyer and the seller. [See Chapter 3]

After the purchase agreement prepared by the agent is signed by the buyer, the offer will be submitted to the seller. The seller will then consider whether to accept the offer, counter with another offer, or reject it without a counteroffer.

Analyzing the purchase agreement

Form 150, **Purchase Agreement**, is used to prepare and submit the buyer's **written offer** to purchase a one-to-four unit residential property on terms such as conventional financing, an assumption of existing loans or a carryback note. Also, Form 150 is properly used by sellers in a counteroffer situation to submit a **fresh offer** to sell the real estate.

The purchase agreement offer, if accepted by the seller, becomes a binding contract between the buyer and seller. Its terms must be complete and clear to prevent any misunderstandings over enforcement of the agreement. Form 150 is a comprehensive "boilerplate" purchase agreement with provisions which serve as a **checklist**, presenting the various non-governmental financing arrangements available to a buyer when making an offer to purchase property.

Preparing the purchase agreement

The following instructions are in reference to the excerpt from **first tuesday** Form 150, **Purchase Agreement**, for offers to buy conventionally financed one-to-four residential units located in California. Due to the fact that a majority of offers are written up by the buyer's agent, the provisions in the form are drafted to provide the buyer with results a prudent buyer would want in an offer. [See Figure 1]

The numbers on the instructions correspond to the numbers given provisions in the form.

The following instructions are an excerpt from **first tuesday** Form 150 to include provisions setting forth the terms for a carryback transaction.

Terms for payment of the purchase price:

3. *Cash down payment:* **Enter** the dollar amount of the buyer's cash down payment toward the price.

3.1 **Enter** the description of any other consideration to be paid on the price, such as trust deed notes, personal property or real estate equities (an exchange), and enter the dollar amount of its value.

4. *New trust deed loan*: **Check** whether any new financing will be a first or second trust deed. **Enter** the amount of the loan, the monthly payment, the term of the loan and the rate of interest. **Check** whether the interest will be adjustable (ARM) and **enter** the index name. **Enter** the dollar amount the loan points are not to exceed.

4.1 *Buyer's loan qualifications*: **Check** the box to indicate the seller is authorized to cancel the agreement if the buyer is to obtain a new loan and fails to deliver documentation from a lender indicating he has been qualified for a loan. **Enter** the number of days the buyer has after acceptance to deliver written confirmation of his qualification for the loan.

5. *First trust deed note*: **Check** the appropriate box for a "subject-to" transfer or an "assumption" if the buyer is to takeover the seller's existing loan. **Enter** the lender's name. **Enter** the remaining balance, monthly principal and interest payment, and interest rate on the loan. **Check** whether the interest is adjustable (ARM) and **enter** the index name. **Enter** any monthly impound payments made in addition to the principal and interest paid.

5.1 *Loan balance adjustments:* Check the box indicating the desired financial adjustment for loan balance differences at the close of escrow.

5.2 *Impound balances:* **Check** whether the impound account transferred to the buyer will be with or without a charge to the buyer.

6. *Second trust deed note*: **Check** the appropriate box for a "subject-to" transfer or an "assumption" of the note by the buyer. **Enter** the lender's name. **Enter** the remaining balance, the monthly principal and interest payment and the interest rate on the loan. **Check** whether the interest is adjustable (ARM) and if so, **enter** the index name. **Enter** the due date on the note.

7. *Bond or assessment assumed*: **Enter** the balance owed on bonds and special assessment liens (such as Mello-Roos improvement bonds) which are not *ad valorem* property taxes and will remain unpaid and become the responsibility of the buyer on closing.

*Editor's note — **Improvement bonds** are obligations of the seller which are assumed by the buyer Thus, the bonds become part of the price paid for the property. Some purchase agreements place these bonds in the property tax provisions but then fail to prorate and charge the unpaid amount to the seller, as is done for ad valorem taxes.*

8. *Seller's carryback*: **Enter** the amount of the carryback note to be executed by the buyer. **Enter** the monthly payment, interest rate, and the due date for the final/balloon payment.

8.1 *Special carryback provisions*: **Check** or **enter** any special provisions to be included in the carryback note or trust deed.

8.2 *Carryback disclosure:* **Fill out** and **attach** the **Carryback Disclosure Statement** as an addendum.

Editor's note — Further approval in escrow creates a buyer's contingency allowing for cancellation until time of closing on one-to-four residential units.

8.3 *Request for Notice of Default and Notice of Delinquency:* **Provides** for the buyer to enter into a Request for Notice of Delinquency (NODq), and to pay the costs of recording and serving it on senior lenders.

8.4 *Buyer creditworthiness:* **Provides** for the buyer to hand the seller a completed credit application. **Enter** the number of days in which seller may cancel the transaction for reasonable disapproval of the buyer's credit application and report.

8.5 *Approval of creditworthiness*: **Enter** the number of days in which the seller may cancel the transaction for reasonable disapproval of the buyer's credit application and report.

8.6 *Subordination:* **Provides** for the seller to terminate this transaction if the parameters agreed to for financing by an assumption or origination of a trust deed loan with priority on title to the carryback note are exceeded.

8.7 *Personal property as security*: **Requires** the buyer on the transfer of any personal property in this transaction to execute a security agreement and UCC-1 financing statement to provide additional security for any carryback note.

9. *Purchase price*: **Enter** the total amount of the purchase price as the sum of lines 3, 3.1, 4, 5, 6, 7 and 8.

Chapter 3 — Required disclosures on seller carrybacks

This chapter discusses the financing disclosures a broker must make or consider making to a buyer and seller considering the risks in a carryback transaction.

Mandated notices for risk analysis

A seller is willing to help finance the sale of his one-to-four unit residential property by carrying back a note and trust deed, sometimes called an *installment sale* or *credit sale*.

The seller's listing agent locates a qualified prospective buyer. The agent prepares an offer on a purchase agreement form and presents it to the buyer for his approval and signature since the buyer is not represented by an agent.

The terms offered for payment of the purchase price include a note and trust deed, to be signed by the buyer in favor of the seller, for the amount of the price remaining to be paid after the down payment and an assumption of the existing loan on the property.

A *Seller Carryback Disclosure Statement* is attached to the purchase agreement as an addendum. The addendum, prepared by the listing agent, contains numerous statements on the financial, legal and risk-of-loss aspects of the carryback note and trust deed. [See Form 300 accompanying this chapter]

The information entered in the **carryback disclosure statement** is based on the terms of the purchase offer, the title conditions, the activities to be undertaken in escrow and the information obtained from the buyer.

However, the agent's disclosures regarding other important aspects of the carryback sale, which might affect the transactional decisions of the buyer or the seller, are not addressed in the carryback disclosure statement.

The statement contains only the legislatively mandated **minimum disclosures** for inclusion in the carryback disclosure statement.

Both the listing agent and the buyer's agent must be assured their respective clients, in addition to receiving the carryback disclosure statement, understand and appreciate the risks and consequences which rise out of the **financial and legal aspects** of the carryback transaction. Disclosure of the **tax aspects** of the transaction depend on the type of property being sold and the agent's willingness to express an opinion on the subject.

Controlled carryback transactions

All brokered transactions for the purchase of **one-to-four unit residential property** involving seller carryback financing are controlled by statute. For one-to-four unit residential properties, a written carryback disclosure statement is **required** to be presented to both a buyer and seller for their review and signatures. [Calif. Civil Code §§2956 et seq.]

FINANCIAL DISCLOSURE STATEMENT

For Entering into a Seller Carryback Note

NOTE: This statement is required to be prepared when the seller carries back a note executed by the buyer as part of the sales price for property containing four-or-less residential units. [Calif. Civil Code §2956]

This statement is to be prepared by the broker who obtains the signature of the person who first offers or counteroffers to buy, sell, exchange or option on terms which include a carryback note.

Both the buyer and the seller shall be handed a copy of this statement and sign it to acknowledge they have read and received a copy.

DATE:_____________, 20______, at____, California.

Items left blank or unchecked are not applicable.

1. This is an addendum to the following agreement:

☐ Purchase Agreement ☐ Option to Purchase (with or without lease)

☐ Counteroffer ☐ Exchange Agreement

1.1 dated _____________, 20______, at ____, California,

1.2 entered into by____, as the Buyer,

1.3 and____, as the Seller.

2. This addendum was prepared by ____.

DISCLOSURES:

3. GENERAL INFORMATION CONCERNING THE TERMS OF PAYMENT:

3.1 The Note to be executed by Buyer is in the original amount of $_______________, payable in constant monthly _____________ installments of $_______________ to include ______% per annum interest, with a final/balloon payment due on _____________, 20______, in the approximate amount of $_______________.

3.2 The note will be secured by a trust deed on the property referred to as_____________________________ ____.

3.3 Should the Note contain a FINAL/BALLOON PAYMENT, the debt is not fully amortized. When the remaining balance of the Note is due and payable, there can now be no assurance that refinancing, modification or extension of the balloon payment will then be available to Buyer.

3.4 Unless stated and explained in an attached ARM addendum, the Note contains a fixed rate of interest with no variable or adjustable interest rates which would increase payments or result in a negative amortization of the debt. [See **ft** Form 263]

3.5 Unless otherwise agreed, the original amount of the Note will be adjusted by endorsement at the close of escrow to reflect differences in the then remaining balance of any underlying trust deed obligation(s) being assumed or obtained.

3.6 ☐ The Note and trust deed to be carried back by Seller is of the all-inclusive variety, and will contain provisions passing through to Buyer any prepayment penalties, late charges, due-on sale or further encumbrance acceleration and future advances due on the underlying wrapped loans.

4. SPECIAL PROVISIONS AND DISCLOSURES CONCERNING THE CARRYBACK NOTE AND TRUST DEED:

4.1 ☐ The all-inclusive Note and trust deed to be carried back by Seller contains provisions calling for Seller to place the Note on contract collection with any institutional lender or real estate broker, other than Seller, and the collection agent will be instructed to first disburse funds on payments due senior encumbrances. **NOTE: Inclusion of this provision may cause adverse income tax consequences for Seller.**

4.2 A joint protection policy of title insurance will be delivered to Buyer and Seller insuring their interests in title on the close of escrow.

4.3 The trust deeds and grant deeds to be executed will be recorded with the county recorder at the close of escrow.

4.4 Seller will be named, through escrow, as a loss payee under the hazard and fire insurance obtained by Buyer.

4.5 A tax reporting service ☐ will, or ☐ will not, be obtained by Buyer for Seller. If not obtained, Seller will assure himself that real estate taxes have been paid while he holds the Note.

4.6 ☐ Requests for Notice of Default and Notice of Delinquency under California Civil Code Sections 2924b and 2924e will be recorded and served on behalf of Seller on encumbrancers senior to the carryback.

4.7 Seller is aware that in the event of a default under the carryback Note and trust deed, his sole source of recovery is limited to the net proceeds from a foreclosure sale or his subsequent resale of the real estate; and he is not entitled to rental value for Buyer's occupancy or a deficiency money judgment under the Note. [Calif. Code of Civil Procedure §580b]

4.8 Buyer ☐ shall, or ☐ shall not, receive net proceeds or cash back upon the close of escrow. Amount to be received is $_______________; source of funds ____; reason for receipt ____.

4.9 The Note shall include the following provision: "This note is subject to Section 2966 of the Civil Code, which provides that the holder of this note shall give written notice to the trustor, or his successor in interest, of prescribed information at least 90 and not more than 150 days before any balloon payment is due."

5. ENCUMBRANCES SENIOR AND PRIOR TO SELLER'S CARRYBACK TRUST DEED AND NOTE:

5.1 Conditions of encumbrances, with priority over Seller's carryback Note and trust deed, which will remain or be placed of record at time of closing are as follows:

	First Trust Deed	Second Trust Deed
Original balance	$_______________	$_______________
Current balance	$_______________	$_______________
Interest rate	______% ☐ ARM	______% ☐ ARM
	Type: ___________	Type: ___________
Monthly payments	$_______________	$_______________
Due date	________, 20____	________, 20____
Balloon payment	$_______________	$_______________
Current defaults	$_______________	$_______________

5.2 If any of the senior encumbrances contain a due date, it may be difficult or impossible to refinance, modify or extend the balloon payment in the conventional mortgage marketplace.

6. BUYER CREDIT INFORMATION (SUPPLIED BY BUYER):

6.1 Buyer to hand Seller a completed credit application on acceptance. [See **ft** Form 302]

6.2 Seller may terminate the agreement within ______ days of receipt of the credit application by delivering to Buyer, Buyer's Broker or Escrow written Notice of Cancellation based on Seller's disapproval of Buyer's credit. [See **ft** Form 183]

7. BROKER DISCLOSURES:

7.1 Credit data is supplied by Buyer. Broker knows of no falsity or omission concerning Buyer's credit information.

7.2 This statement and its contents are statutorily required disclosures and do not limit Broker's duties to disclose other material facts about Seller to Buyer or Seller about the carryback financing arrangements and which are known to Broker or his agent.

7.3 Buyer and Seller are not to sign this statement until they have read and understood all of the information in it. All parts of the form must be completed before signing below.

7.4 ☐ See attached addendum for additional disclosures which are part of this disclosure. [See **ft** Form 250]

8. OTHER: ____

____

Date:_____________, 20______	Date:_____________, 20______
Buyer's Broker: _______________________	Seller's Broker: _______________________
By:___________________________________	By:___________________________________
I have read and received a copy of this statement.	**I have read and received a copy of this statement.**
Date:_____________, 20______	Date:_____________, 20______
Buyer: _______________________________	Seller: _______________________________
Buyer: _______________________________	Seller: _______________________________

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Even the use of a *masked security device*, such as a land sales contract, lease-option or unexecuted purchase agreement with interim occupancy, requires written carryback disclosure statements. The written disclosure statements inform the buyer and the seller about the seriousness of the risks presented by failing to use grant deeds, notes and trust deeds to evidence an installment sale when the buyer takes possession. [See Form 300; see **first tuesday** Forms 309 and 312]

On the sale of a one-to-four unit residential property, any credit extended by the seller to accommodate the buyer's deferred payment of the purchase price requires a written carryback disclosure statement when the credit extended to the buyer includes:

- interest or other finance charges;
- five or more installments running beyond one year;
- an installment land sales contract;
- a purchase lease-option or a lease-option sale;
- credit (note) to adjust equities in an exchange of properties; or
- an all-inclusive note and trust deed (AITD). [CC §2957]

Carryback disclosure statements are not legally required in carryback transactions creating **straight notes** which do not bear interest or include finance charges. However, carryback disclosures should be included as a matter of good brokerage practice since the risks and issues for the buyer and seller are similar.

Consider a real estate agent who is acting as a property manager or leasing agent negotiating a lease for the landlord of a single family residence (SFR).

A prospective tenant makes an offer to lease the property. The offer contains an option to purchase the property on expiration of the lease. The terms for payment of the price under the proposed option include:

- a **carryback note**, to be executed on exercise of the purchase option (on expiration of the lease) for the balance of the seller's equity in the property after the down payment; and
- part or all of the lease payments are to apply as a credit toward the price and down payment on the property.

Here, the tenant's offer to lease and be granted a purchase option provides for a credit toward the price which **builds up an equity** in the property for the buyer. Thus, the agent is required to prepare the mandated carryback financing disclosures on a written form as an addendum to the lease-option. [See **first tuesday** Form 309]

Who prepares the disclosure

A carryback disclosure statement must be **prepared and submitted** to all parties in a carryback transaction on one-to- four unit residential property by:

- the real estate broker, or his agent, who **negotiated** the carryback sales transaction and prepared the buyer's purchase offer; or

- the buyer or seller who is a real estate licensee or attorney, when neither the buyer nor the seller is represented by a broker. [CC §2957(a)(2)]

When both the buyer and seller are represented by **different brokers**, the carryback disclosure statement is prepared by the broker or agent who prepared the buyer's offer.

Many participants in a carryback sale transaction are not required to make carryback disclosures, including:

- escrow officers [CC §2957(a)(3)];
- attorneys representing a party and not also acting as a real estate licensee [CC §2957(a)(1)]; and
- individual buyers and sellers when acting as principals without the assistance of a broker, unless they are real estate licensees or attorneys. [CC §2957(a)(1)]

Offer includes disclosures

The best policy for a **buyer's agent** is to eliminate the need for further approval of the statutory carryback disclosures by **preparing and attaching** a carryback disclosure statement as an addendum to the purchase agreement. If the disclosure statement is not attached, it would be prudent for the **listing agent** to include it as an addendum to a counteroffer to eliminate the disclosure contingency.

If neither the buyer's or seller's agent prepares and includes the disclosures as an addendum to the offers or counteroffers, then, as a minimum requirement, the **buyer's agent** is responsible for preparing the disclosures and obtaining both the buyer's and seller's signature **prior to closing** the carryback sales escrow. [CC §2959]

However, after a purchase agreement has been entered into, and until the carryback disclosure statement is approved by the buyer and seller in a one-to-four unit transaction, a **statutory contingency** exists in favor of the buyer allowing him to cancel the transaction. The contingency does not arise if the carryback disclosure statement is attached as an addendum to the offer or counteroffer.

If the buyer receives the carryback disclosures after entering into the purchase agreement and discovers a reasonable basis for disapproving it, he may cancel the transaction and terminate his obligation to purchase the property.

However, the buyer may not arbitrarily cancel the sale when he is presented with the carryback disclosure statement for his acknowledgment and approval during escrow. To cancel, the buyer must act in good faith by showing the carryback disclosures are inconsistent with his **reasonable expectations** when he entered into the purchase agreement.

After closing, the only legal remedy available to the buyer or seller for inadequate or nonexistent financial disclosures is to pursue the broker for any money losses actually incurred as a result of the nondisclosure. The judicial remedy for failure of a broker or his agent to make mandated carryback disclosures is no less than a return of all brokerage fees and other benefits to the injured parties they received on the transaction.

Contingency exercised to cancel

Consider a buyer and seller of a single family residence who enter into a purchase agreement. The terms call for carryback financing in the principal amount of $50,000 with an interest rate of 9%, payable in monthly installments with a 30-year amortization and a five-year due date for a final/balloon payment.

The purchase agreement does not state the amount of the balloon payment due on the carryback note at the end of five years. The risks imposed and the consequences of a five-year due date are not discussed.

A carryback financial disclosure statement is not presented to the buyer or seller for their signatures as part of the purchase agreement or counteroffer. Thus, closing is automatically contingent on the buyer's and seller's **further approval** of the financial and legal aspects of the carryback note and trust deed as presented in the carryback disclosure statement.

Prior to closing, the buyer receives the carryback disclosure statement. He discovers his final balloon payment at the end of five years will be approximately $48,300. The buyer is now concerned about the financial risks of ownership since he has no assurance he will be able to refinance, modify or extend the note, much less have the ability to accumulate funds for payoff of the final/balloon payment.

The buyer cancels the purchase agreement and escrow, claiming he did not previously realize the extent of the financial risk created by the due date in the carryback financing. He is now aware he could be forced, by the due date, to either sell the property or lose it to foreclosure should he be unable to arrange refinancing or an extension of the carryback note.

Can the buyer cancel the transaction as permitted by statutes on a late financial disclosure?

Yes! The buyer did not sign the carryback disclosure statement prior to agreeing to buy the property. This failure triggers the **statutory further-approval contingency** allowing the buyer to cancel the transaction. The risks of loss imposed by the amount of the final/balloon payoff were far greater than the buyer realized when entering into the purchase agreement. Thus, the buyer has justification for exercising his right to cancel since the sale did not meet his reasonable expectations.

Approximations when uncertain

A purchase agreement entered into by a buyer and seller calls for:

- a 10% down payment;
- a new loan of no less than 60% of the purchase price; and
- the seller to carry back a note for the balance of the purchase price at 9% interest, amortized monthly over 30 years with a ten-year due date.

Thus, the precise amount of the carryback note provided for in the purchase agreement could be any amount up to 30% of the purchase price, depending on the loan amount available from a lender.

When the agent prepares the carryback disclosure statement, the amount of the carryback note and new loan can be disclosed as dollar figures he **reasonably believes** will exist at the time of closing. The carryback figures may be an approximation of the unknown amounts.

The **approximation** must be clearly identified as "approximate," or "approx.," in the carryback disclosure statement, and be based on the best information available to the agent. The approximation may not be used to evade compliance with disclosure laws. [CC §§2960, 2961]

Further, as amounts approximated in the original carryback disclosure statement become certain and are available to the agent, he must disclose the new figures in a written amendment signed by both the buyer and seller. [CC §2962; see **first tuesday** Form 250]

However, if figures and facts presented in the carryback disclosure statement change due to actions taken by the buyer or seller after making the disclosures, the agent is not responsible for amending the carryback disclosure statement. [CC §2960]

Buyer's ability to pay is fundamental

A buyer's ability to meet the terms and conditions of a carryback note is of financial importance to a seller who is carrying back a note on a sale. Thus, a listing agent must alert his seller to facts about the buyer's financial condition which are known to the listing agent and not previously disclosed to his seller.

For example, the listing agent locates a buyer willing to purchase his seller's property on terms which include a carryback note and assumption of the seller's existing trust deed debt. The agent advises the seller that the buyer is financially qualified to handle the cash down payment and monthly payments on the carryback financing, arrangements the buyer needs to pay for the balance due on the purchase price.

Believing his agent's representations regarding the buyer's financial qualifications, the seller agrees to carry paper to finance the sale.

Before escrow closes, the buyer tells the agent he does not have the cash down payment and will need to obtain a loan. The listing agent does not disclose the buyer's lack of capital to the seller. Further, the listing agent makes a loan to the buyer to help fund the down payment of the property.

Escrow closes and the buyer takes title to the property. Shortly after taking title, the buyer defaults on the carryback note and trust deed held by the seller. The seller suffers a total loss on his carryback note due to a foreclosure sale on the first trust deed.

The seller then discovers his listing agent made a separate loan to the buyer for the down payment. The seller also discovers the agent knew the buyer was financially unstable prior to closing the transaction.

In this scenario, the listing agent had an agency duty to advise the seller of the buyer's reduced financial capability to repay the carryback note, a significant adverse fact which came to the listing agent's attention prior to closing. Thus, the agent and the agent's broker are liable to the seller for the seller's money losses on the carryback note. The listing agent failed to disclose his knowledge of the negative aspects of the buyer's revised or altered financial status. [**Ziswasser** v. **Cole & Cowan, Inc.** (1985) 164 CA3d 417]

A seller willing to enter into a credit sale **needs to know** the prospective buyer will be able to make the payments and pay the operating costs incurred as owner of the property. As carryback financing becomes more prevalent during cyclical periods of declining real estate prices and tight mortgage money conditions, more unqualified buyers appear with whom agents must contend.

To filter out unqualified buyers as part of the carryback disclosure process, the listing agent has an **affirmative duty** to obtain a written financial statement from the buyer and hand it to the seller of one-to-four unit residential property. [See Form 300 §4]

Different risks face creditors

The primary purpose of a carryback disclosure statement is to inform a seller that owners and lenders are bound by different rules and face different risks based on their respective possessory and security interests in real estate.

For example, while a buyer is concerned with paying no more than the *fair market value* (FMV) for a property, the carryback seller is concerned with his loan-to-value (LTV) ratio, whatever the price may be, since he will become a "financier" on the close of escrow.

Typically, a seller wants to receive the highest sales price negotiable for his real estate. However, the seller as a carryback lender wants assurance the buyer's down payment is a large enough percentage of the purchase price to establish **adequate equity value** in the real estate, over and above the amount of the carryback trust deed note, to allow full recovery of the carryback note from the property should a default require the seller to foreclose on the property. Any lesser amount of equity exposes the seller to a risk of loss.

Risks of loss as a lender

A carryback seller must be aware he takes on the **role of a lender** in a carryback sale, with all the risks and obligations of a secured lender's position. [See Chapter 3]

Above all, the seller must be willing to accept the **risk of default** by the buyer. Should a default on installment payments occur, the seller could be forced to advance cash to make payments on the senior trust deed loan while he forecloses on the property in an effort to recover the amounts owed on the carryback note. Also, a **risk of impairment** to the security exists should the buyer default on trust deed provisions for the payment of taxes, assessments and insurance premiums.

Costs incurred in foreclosing and reselling the property can quickly turn a low-downpayment, high-interest-rate sale into a cash drain for the seller. [See Chapter 20]

Additionally, the seller must understand a carryback note is *nonrecourse paper*. Thus, the seller will be barred from obtaining a deficiency judgment from the buyer for any part of the carryback debt not satisfied by a foreclosure sale. [Calif. Code of Civil Procedure §580b]

On a default by the buyer, the carryback seller could suddenly find himself returned to his original position — owning property he no longer wanted to own and still subject to the senior trust deed. Further, the seller will incur out-of-pocket costs for:

- foreclosure;
- carrying the property;
- any reduction in property value or property taxes for reassessment;
- a modified (higher) interest rate on the old loan; and
- profit taxes on any untaxed principal in the down payment.

As with any creditor, if the **premium** in the price, down payment and interest rate on the carryback note are sufficient, the benefits of carryback financing outweigh the risks of loss.

Agency duties and carryback risks

Sellers often do not know what risks of loss exist when carrying back paper, much less understand or even ask about them. Brokers and their agents who represent carryback sellers under a listing must be knowledgeable enough to provide essential risk-management information for the care and protection of their clients.

Listing agents who do not know or understand the risks of carrying back paper on a sale often dismiss them. However, sellers need to be advised that they must consider more risk reductions and remedies than just "taking back the property" if their buyer defaults. If a seller does not inquire about the risks, his listing agent has an **affirmative duty** to voluntarily advise the seller of the **risks known** to the broker and the agent, and recommend any due diligence investigation or analysis the agent believes they or the seller should undertake in a carryback sale.

Risks posed to a creditor involved in holding carryback paper differ dramatically from the risks of owning real estate. When the seller carries back paper on the sale of property, his ownership interest is exchanged for a creditor's (lender's) secured position in the property, called a *security interest*.

Chapter 4 — Further approval of the buyer's credit

This chapter comments on a carryback seller's need to investigate and analyze a buyer's creditworthiness and capacity to pay.

The informed seller carries paper

An offer submitted by a buyer to purchase real estate calls for the seller to carry back an **unsecured promissory note** for the balance of the purchase price after the cash down payment and the assumption of an existing loan on the property. The seller is given ten days after acceptance of the offer to further approve the buyer's creditworthiness and net worth, or cancel the transaction. [See **first tuesday** Form 150 §§8.4 and 8.5]

The buyer wants to acquire the property clear of any carryback encumbrance so the equity in the property can be used to finance the acquisition of other property.

On presentation of the offer, the seller's listing agent advises the seller that the buyer's financial statements indicate the buyer's net worth includes the ownership of numerous properties known to the broker and itemized on the buyer's financial statement.

Relying on his agent's representations of the buyer's net worth, the seller accepts the offer. Prompted by the listing agent, the seller approves the buyer's credit, thus waiving the further-approval contingency. [See **first tuesday** Form 182]

Cash back disclosure

Prior to the close of escrow, a buyer informs his listing agent he needs to issue a promissory note to the broker for the amount of the brokerage fee to replace the cash fee the seller has agreed to pay the broker. The buyer has insufficient funds for the agreed-to down payment. To close the transaction without bringing the buyer's lack of funds to the seller's attention, the broker enters into a "cash back" arrangement with the buyer. This arrangement will help the buyer fund the down payment out of which the seller will pay the broker's fee.

Under the arrangement, the buyer and the agent will exchange a check from the broker for a note from the buyer for the amount of the broker's fee. On closing and deposit of the fee into the agent's account, the agent will hand his personal check to the buyer. In turn, the buyer will issue a promissory note to the broker. The brokerage fee paid to the broker (and shared with the agent) by the seller on closing will cover the check issued by the agent to the buyer.

Further, the buyer finances the remaining portion of the down payment through a new loan arranged by the listing agent with a private lender. Thus, the buyer has restructured the entire down payment to avoid the investment of any of his **personal funds**.

The seller is not informed of the purchase-assist loan, nor of the cash back arrangement. Also, the agent is aware the representations of the properties and the financing listed on the buyer's financial statement handed to the seller significantly overstate the buyer's net worth.

The transaction closes. Eventually, the buyer defaults on the unsecured carryback note, which is recourse paper. The seller is only able to recover a portion of the outstanding balance on the carryback note from the buyer.

The seller seeks to recover his loss on the carryback note from the broker, claiming the broker and his listing agent wrongfully induced him to accept the unsecured carryback note.

Is the broker or his listing agent liable for the seller's losses due to the buyer's default?

Yes! The broker and his listing agent are both liable for the seller's losses. The agent intentionally misrepresented the buyer's ability to perform on the carryback note to induce the seller to enter into the installment sale with the buyer. [**Alhino** v. **Starr** (1980) 112 CA3d 158]

Listing broker's duty to seller

The duty owed the seller by the broker's listing agent to disclose the **buyer's credit status** includes:

correctly representing to a carryback seller a buyer's ability to meet the obligations imposed on him by entering into a carryback note;

- disclosing information about the prospective buyer's/borrower's identity, occupation, employment, income, and credit data as known to the licensee;
- disclosing the buyer's existing and future loan obligations, including payment history and any pending bankruptcy known to the broker and his listing agent; and
- advising on any credit investigation which should be conducted.

Also, written disclosures itemizing the buyer's credit information are mandated on all sales involving one-to-four unit residential properties when the seller carries back a portion of the sales price. [Calif. Civil Code §§2956 et seq.]

Thus, the listing agent provides his seller with the buyer's credit information so the seller can make an informed decision to either proceed with the transaction or cancel it under a further- approval contingency in the purchase agreement. All disclosures must be made in *good faith* by the buyers, brokers and agents to meet the objective of the credit investigation. [CC §2961]

Any real estate agent who misrepresents a buyer's credit information or makes false statements to the carryback seller about the buyer's ability to repay the carryback note, is not only liable for money damages, but faces suspension or revocation of his license for committing fraud. [Calif. Business and Professions Code §10176]

The need for credit checks

A carryback seller must determine the creditworthiness of the buyer for the same reason a landlord must obtain reliable credit information on prospective tenants — will they, and are they able to, pay as agreed.

Accurate credit information on the buyer helps the seller analyze the **risk of default** when extending credit to the buyer. Also, the seller must assure himself the buyer will **maintain the property unimpaired** under the carryback trust deed. In other words, if the buyer is unqualified, there is justification for the seller to cancel the transaction.

The buyer must have the financial ability and credit history to pay both the first trust deed loan and the second trust deed note carried back by the seller before the seller approves and proceeds to close the sale. Any default by the buyer on the first trust deed jeopardizes the seller's security interest in the property under his second trust deed lien.

The listing agent checks the buyer's creditworthiness and ability to perform by:

- analyzing an application for credit, credit reports, telecredit checks and criminal background reports;
- reviewing financial statements, both an operating statement (profit and loss report) and a balance sheet (net worth statement);
- contacting the buyer's creditors (sellers, landlords, lenders) for their experiences with the buyer's payment history; and
- inspecting properties owned by the buyer to determine the level of care and maintenance the properties receive which are owned and managed by the buyer.

All carryback sellers face the risk a buyer will default, no matter how wealthy, conscientious and seemingly qualified the buyer might be. On any default in payments on a trust deed note, the seller's **sole source of recovery** is a resort to the secured property, unless the note is subordinated to a construction loan or additionally secured by property other than the property sold.

Even an existing trust deed lender has a right to obtain credit information from the buyer on a change of ownership. The lender needs to make an informed decision as to whether the risk of default in the payments or care and management of the property will increase under the new ownership, called *impairment*. [**Santa Clara Savings and Loan Association** v. **Pereira**(1985) 164 CA3d 1089]

The right to obtain credit information also applies to private parties such as carryback sellers. For example, private lenders rely on their agents to obtain necessary information on the borrower's ability to comply with the terms of both the **note** (payments) and the **trust deed** (care and maintenance).

A private lender does not typically have the resources of institutional lenders to personally investigate and assess a buyer's creditworthiness and management capabilities prior to making a loan. Thus, a broker or an agent who assists private lenders and carryback sellers helps them to determine the buyer's ability to operate the property and his propensity to make payments on a promissory note. [**Dawn Investment Co., Inc.** v. **Superior Court of Los Angeles** (1982) 30 C3d 695]

The credit worthiness contingency

A listing agent has the duty to obtain accurate credit information and disclose any facts known or readily available to him which might affect the seller's decision to carry paper in the transaction.

A **carryback disclosure statement** should be attached to any purchase agreement containing a carryback note. The carryback disclosure statement is mandated on the sale of four-or- less residential units. However, a prudent listing agent will also require a disclosure statement in carryback transactions on **all types** of property. [CC §§2956 et seq.; see **first tuesday** Form 300]

Both the carryback disclosure statement and the purchase agreement includes a credit approval contingency. The **further-approval contingency** calls for the buyer to hand the seller a completed *credit application*. [See Form 302 accompanying this chapter]

CREDIT APPLICATION

Individual

DATE: _____________, 20______, at ____, California.

THIS CREDIT APPLICATION is for the amount of $_______________.

Property address: ____

Received from Applicant(s) $_______________, ☐ cash, or ☐ check, for a consumer credit report which is a non-refundable cost and not a deposit.

Applicant(s):

Applicant One ____
(Last Name) (First Name) (Middle Name) (Sr., Jr., etc.)

Social Sec. # ______________________ Drivers Lic. # ____________________ State______

Applicant Two ____
(Last Name) (First Name) (Middle Name) (Sr., Jr., etc.)

Social Sec. # ______________________ Drivers Lic. # ____________________ State______

Additional Occupant(s): Name ____

Name ____

Rental History: Have you ever been party to an eviction? ☐ Yes ☐ No Filed bankruptcy? ☐ Yes ☐ No

Present Address ____

City ____ Zip ____________________

Length of Residency _____________ Monthly Rent $_______________

Landlord/Agent ____

Address ____

City ______________________________ Zip ____________________ Phone ____________________

Reason for Moving ____ Moving Date ____/____/____

Previous Address ____

City ____ Zip ____________________

Length of Residence _____________ Monthly Rent $_____________

Landlord/Agent ____

Address ____

City ______________________________ Zip ____________________ Phone ____________________

Employment:

Applicant One

Employer ____

Address ____

City ______________________________ Zip ____________________ Phone ____________________

Length of Employment _____________ Position ______________________________ Wages ___________

Pay Period ____________________ Union ____

Previous Employer ____

Address ____

City ______________________________ Zip ____________________ Phone ____________________

Applicant Two

Employer ____________________

Address ____________________

City ____________ Zip ____________ Phone ____________

Length of Employment ________ Position ____________ Wages ________

Pay Period ____________ Union ____________

Previous Employer ____________________

Address ____________________

City ____________ Zip ____________ Phone ____________

Additional Income Amount $________ Source ____________

Recipient ____________________

General Credit Information:

Automobile One: Make ____________________

Year ________ Model ____________ Lic. #/State ____________

Lender ____________________

Automobile Two: Make ____________________

Year ________ Model ____________ Lic. #/State ____________

Lender ____________________

Bank/branch ____________________

Check Acc. # ____________ Savings Acc. # ____________

Bank/branch ____________________

Check Acc. # ____________ Savings Acc. # ____________

Credit References:

1. ____________________

Address ____________________

Account # ____________ Balance due $________ Phone ____________

2. ____________________

Address ____________________

Account # ____________ Balance due $________ Phone ____________

Personal Reference ____________________

Address ____________________ Phone ____________

Personal Reference ____________________

Address ____________________ Phone ____________

Nearest Relative (name/relationship) ____________________

Address ____________________ Phone ____________

I/We declare all information given in this application is true and correct. I/We authorize your credit reporting agency to obtain and verify a complete consumer report and supply the information obtained to you.
This information is not privileged.

Date: ____________, 20______

Name: ____________________

Signature: ____________________
(Applicant 1)

Name: ____________________

Signature: ____________________
(Applicant 2)

I acknowledge receipt of this credit application and accompanying payment.

Seller or Lender: ____________________

Signature: ____________________

Phone: ____________________

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The agent preparing an offer should consider having the buyer fill out the **credit application** on commencement of negotiations and attach it to the buyer's purchase agreement offer as an addendum. Early disclosure helps the seller to determine the buyer's sincerity and good-faith willingness to cooperate in the credit analysis process.

A review of the buyer's financial statements and the agent's verification of earnings and funds can be cleared during the contingency period. The credit contingency then allows the carryback seller to terminate the purchase agreement by a written *Notice of Cancellation* should he disapprove of the buyer's creditworthiness. [See **first tuesday** Form 150 §10.5]

However, the credit contingency does not give the carryback seller the unrestricted right to withdraw from a binding and otherwise enforceable purchase agreement.

For example, a carryback seller enters into a purchase agreement containing a credit approval provision which gives him the right to cancel the transaction based on the buyer's lack of creditworthiness. [See **first tuesday** Form 150 §§8.4 and 8.5]

During the contingency period and before the seller approves the buyer's credit, the seller changes his mind about selling the real estate. He decides to cancel the transaction by using the credit contingency as a "weasel clause", or "back door provision", in an attempt to escape enforcement of the purchase agreement.

However, the seller has no grounds for disapproving the buyer's credit. No derogatory information has been received about the buyer's creditworthiness or ability to perform on the purchase agreement or the carryback note.

The seller must have good reason to disapprove the buyer's credit and cancel the transaction. A reason to cancel the transaction must relate to the creditworthiness sought to be determined under the contingency provision. If the seller does not have a good reason to cancel, but does so anyway, he has breached the purchase agreement in bad faith by wrongfully using the credit contingency, and thus, no grounds for cancellation exists. [**Lyon** v. **Giannoni** (1959) 168 CA2d 336]

A credit report and telecredit check

A review of a buyer's creditworthiness requires accurate credit history data on the buyer. **Credit history** obtained from reporting agencies includes *consumer credit reports* and *telecredit checks*.

The **telecredit check** reviews the buyer's check writing history and informs the agent if the buyer has written bad checks in the past.

A **consumer credit report** contains information about a consumer's creditworthiness or credit standing supplied by a consumer credit reporting agency. The credit application form can require the buyer to cover the cost of the credit report.

A credit report does not assure the future performance of the buyer to repay the note, nor does the report demonstrate the buyer's ability to pay.

Properly reviewed, a credit report helps to establish the buyer's past performance in repaying money obligations. Money obligations include amounts owed on loans or financing agreements, on judgments or tax liens, or for late penalty charges on retail and bank credit accounts. The credit report is used by the broker to establish an individual's eligibility for:

- credit to be used for personal, family or household purposes;
- employment purposes; or
- rental of a dwelling unit. [CC §1785.3(c)]

When the carryback transaction involves a carryback note of $50,000 or more, a consumer credit report will also contain information not otherwise available in a credit report, regarding:

- bankruptcies predating the report by more than 14 years;
- paid tax liens or accounts predating the report by more than seven years;
- unlawful detainer (UD) actions where the landlord prevailed; and
- records of criminal activity predating the report by more than seven years.

Persons seeking credit information must identify themselves to the reporting agency, state their purpose for seeking the information and certify the information will be used for no other purpose than what is stated. [CC §1785.14]

An agent seeking information on a buyer will be refused a credit report unless the buyer to be investigated signs a release form for the information, typically included in credit application forms.

The release requirement is waived if the broker is a member of a credit reporting agency's credit association. Credit reports are provided at a preset cost-per-request by the agency to the broker (or agent) member for a one-time membership fee and a minimum monthly billing.

Membership in a credit association requires applicants (brokers or agents) to have their own creditworthiness reviewed by the agency.

The credit reporting agency will provide the necessary notice to the buyer being investigated.

Although necessary for completing a credit clearance, a credit report does not contain information on the buyer's capacity to pay, called *net worth*, or his propensity to commit a crime.

Financial statements for income and worth

Two financial aspects of a buyer's ability to perform on the carryback note must be investigated:

- the ability of the property's income to cover the **expenses** and carry the **debt service** if it is income producing; and
- the ability of the buyer to personally service any **negative cash flow** resulting from the debt burden or lack of rental income or the owner's use of property, called *implicit rent*.

To investigate the property's ability to carry its debt service, the property's income and expenses are analyzed by using the *Annual Property Operating Data Sheet* (APOD). [See **first tuesday** Form 352]

If the property's income is unable to support its operating expenses and debt service, then the seller must look for other abilities of the buyer to carry the negative cash flow caused by the debt. The buyer's personal capacity to pay is investigated by a review of financial statements delivered by the buyer itemizing his income/expenses and net worth.

The buyer's income includes his base salary, overtime, bonuses, commissions, interest earned, dividends, and rental income. Income from alimony, child support, or other separate maintenance income such as social security and military benefits does not have to be reported on the financial statement if the buyer does not want the income to be considered as available for repayment of the property's debt.

Personal expenses by a buyer are broken down into housing expenses and all other expenses.

The buyer's monthly housing expenses include real estate loan payments, rent, property taxes, association charges, homeowner's/tenant's insurance premiums and utilities.

When housing expenses are added to all other expenses, such as alimony, child support, income taxes and other installment payments such as credit cards, automobiles, etc., the buyer's total expenses are determined.

The buyer may be self-employed, or involved in a business, rental or investment activity which provides the buyer with his primary source of income used to establish his creditworthiness. For a self-employed buyer, **financial statements** such as an *operating statement* and *balance sheet* on each business, rental or investment activity are needed to determine any profit or loss and net worth, together with tax returns for at least two years, for confirmation of the financial statements.

Assets of the buyer include cash balances in checking, savings and other accounts receivable. Also included is the current market value of stocks, bonds, personal property, businesses and real estate owned by the buyer. Finally, the current values of vested interests in retirement funds and insurance policies are included.

The buyer's liabilities include the balance owed and monthly payments on credit cards, open credit lines, alimony and child support. Also, loans secured by assets must be listed as liabilities. A buyer's **net worth** is the total value of his assets minus his total debt obligations. Net worth is the bottom line shown on the financial statement identified as the *balance sheet*.

Evaluating credit information

Once a listing agent has obtained a buyer's credit application and financial statements, the data must be evaluated by that agent and the seller of the real estate. When evaluating the information and disclosures on forms filled out by a buyer, the listing agent and seller must not conduct themselves in a manner which would discriminate against the buyer based on their race, color, religion, sex, sexual orientation, marital status, national origin, ancestry, familial status, source of income or disability of that person. [Calif. Government Code §12955]

The buyer's representations of employment, cash deposits and loans with existing lenders should be verified.

Formulas for determining a buyer's ability to pay for any negative cash flow generated by the purchase of the real estate are structured as expense-to-income ratios.

For example, the Department of Housing and Urban Development (HUD) and Federal Housing Administration (FHA) ratio of housing expenses to gross income should be no more than 29%. The ratio of total expenses to gross income should be no more than 41%.

Institutional lenders generally vary the ratio of housing expenses to gross income to around 30%, and the ratio of total expenses to gross income to around 40%.

However, when applying ratios as guidelines to determine a buyer's creditworthiness, each buyer should be treated individually. A buyer who does not meet the expense-to-income ratio is not necessarily an increased credit risk.

Also, the seller may apply an arbitrary ratio or formula, such as a three-to-one *income-to-debt* ratio, as the only basis of determining the buyer's creditworthiness, as long as the ratio is uniformly applied to all transactions. [**Harris** v. **Capital Growth Investors XIV** (1991) 52 C3d 1142]

Income-to-debt ratios assume all non-qualifying individuals are unable to pay based on arbitrary mathematical formulas.

Qualifying ratios cause the more complete credit reviews of a prospective buyer to be sacrificed for a quick and easy test of their financial ability. By the use of such qualifying ratios, some buyers who may be qualified are not actually good credit risks and some disqualified buyers are actually good credit risks.

Also, requiring employment to be a qualification for prospective buyers unfairly discriminates against people who receive income from investments, annuities, retirement pay, family support or private subsidies.

The carryback seller should review all credit information supplied by the buyer and look for a reason why the buyer qualifies as a good credit risk.

Only after all credit information has been reviewed and creditworthiness has not been established can the seller reasonably cancel the carryback transaction for the buyer's lack of credit.

Chapter 5 Requests for Notice of Default and Notice of Delinquency

This chapter discusses a carryback seller's use of recorded requests for notice to protect his security interest in real estate in the event of a delinquency or foreclose under a senior trust deed.

Protection of the last resort

A seller who carries back a note and trust deed secured by the property sold generally holds a trust deed lien which is junior to a pre-existing trust deed lien held by a lender, called a *senior trust deed holder*.

The carryback seller holding a **second trust deed**, like an equity lender or long-term tenant, needs to protect himself against the foreseeable risk of the loss of his interest in the property due to a delinquency and foreclosure by the senior trust deed holder. A foreclosure sale of the property by the senior trust deed holder would eliminate the carryback seller's trust deed lien on the property, called *exhaustion of the security*.

Two procedures exist for the carryback seller or private lender whose note is secured by a junior trust deed, to receive notice from the senior trust deed holder regarding **defaults** and **foreclosure** proceedings on the senior trust deed:

- **Request for Notice of Default** (NOD) — notice will be sent to the carryback seller or private lender within 10 business days after a senior lienholder initiates foreclosure by recording an NOD; and

- **Request for Notice of Delinquency** (NODq) — notice will be sent to the carryback seller or private lender within 15 calendar days after four consecutive months of unpaid and delinquent monthly installments on the senior trust deed note.

Anyone, whether or not they hold an interest in the property, such as the carryback seller, private lender or tenant of the property, may **record a request** to receive a copy of any NOD which is later recorded under the trust deed identified in the request. The request does not require the consent of the property owner (or anyone else) and may be recorded at any time.

Conversely, the carryback seller or private lender must first obtain the consent of the buyer or owner of the property in order to process a Request for NODq. Consent is best obtained by including a provision in the purchase agreement or loan agreement entered into with the buyer or owner, or on a later modification of a note. [See **first tuesday** Forms 150 §8.3 and 426 §7.6]

The buyer or owner consents to the NODq and the release of information by signing the request form. The request form is then recorded and a copy served on the senior lender through escrow. [See Form 412 accompanying this chapter]

The senior trust deed holder will only release delinquency information to the seller or private lender if the request form is signed by the buyer or owner who originated or assumed the loan.

Use of the request for an NODq is only available to persons with an ownership interest (tenant or co-owner) or security interest in the property. [Calif. Civil Code §2924e(b)]

The NOD Request

Anyone may record a Request for Notice of Default (NOD). A recorded Request for NOD must identify:

- the person requesting a copy of the NOD, called the *requestor*, by name and address; and
- the trust deed on which a copy of the NOD commencing foreclosure is requested.

To be valid, the Request for NOD only needs to be recorded in the county where the property is located. No service of the request on the lender is required.

To initiate foreclosure by a trustee's sale, the trustee, on instructions from the trust deed holder, records the NOD. The NOD states the nature of an owner's money default, and what can be done (if anything) to bring the loan current, called *reinstatement*.

Within 10 business days following the recording of the NOD, the **trustee must mail** two copies of the NOD to each person who recorded a request for notice: one by registered or certified mail, the other by first-class mail. [CC §§2924b(b)(1), 2924b(e)]

When a Request for NOD is not recorded, a carryback seller or private lender whose trust deed is junior to a trust deed on which an NOD has been recorded will still be sent two copies of the NOD **within one month** after the NOD is recorded; one by certified or registered mail, the other by first-class mail. [CC §2924b(c)]

By recording the Request for NOD, the junior lienholder is given an additional 20 days after receiving the NOD to either **reinstate** (bring current) the delinquent loan or **redeem** (pay off) the property, if the owner does not.

However, the trustee's **sending** a copy of the NOD, which is the minimum attempt required to effect service, and the requestor's **receiving** a copy of the NOD are entirely different events.

Receiving an NOD

Foreclosure trustees mail a copy of the recorded notice of default (NOD) to the last address of record, or the present address of the property owner or junior lienholders if it is actually known to the beneficiary or trustee. [CC §2924b(b)]

For example, a Request for NOD is recorded by a carryback seller to reflect a **change of address** from the address given in his recorded junior trust deed. The request calls for a copy of any NOD recorded under the senior trust deed identified in the request form to be sent to the carryback seller at the address of his place of business.

The carryback seller has another change of address, but this time he fails to record another Request for NOD. The buyer's loan payments to the senior lender become delinquent and he fails to bring the loan current.

The trustee records an NOD. A copy of the NOD is mailed to the carryback seller at his new address which was known and provided by the lender. The buyer cures the default during the reinstatement period.

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

REQUEST FOR NOTICE OF DEFAULT AND NOTICE OF DELINQUENCY

By Junior Trust Deed Beneficiary

Request for Notice of Default

Under Calif. Civil Code §2924b, request is hereby made for a copy of any Notice of Default (NOD) and a copy of any Notice of Sale under the Trust Deed recorded on ______________________________________,
as Instrument No. ____________________, Official Records of ______________________ County, California,
executed by ____, as the Trustor,
in which ____ is the Beneficiary, and
____ is the Trustee,
to be mailed to ____, as the Requester,
whose address is ____.

NOTICE: A copy of any Notice of Default and of any Notice of Sale will be sent only to the address contained in this recorded request. If your address changes, a new request must be recorded.

Request for Notice of Delinquency

Under Calif. Civil Code §2924e, request is hereby made for Notice of Delinquency (NODq) under the above described Trust Deed being a lien on property commonly referred to as _________________________________
____,
and being your Loan No. _______________, to be mailed to________________________, as the Requester,
whose address is ____.
Requester is Beneficiary under a Trust Deed recorded on ________________, as Instrument No. ___________,
in the Officials Records of ____ County, California, securing a note
which will be due____________, 20_____.

Consent of Trustor

As Trustor(s) under the above described Trust Deed, I/we hereby consent to this Request for Notice of Delinquency.
Trustor: ___________________________________ Trustor: _______________________________________
(Signature) (Signature)

Date: _____________, 20______ Requester: ____
Date: _____________, 20______ Requester: ____

STATE OF CALIFORNIA
COUNTY OF____
On _______________________________________ before me,
____
(Name and title of officer)
personally appeared ____________________________________
____,

who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

Signature ____
(Signature of notary public)

(This area for official notarial seal)

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Later, the buyer again becomes delinquent on his loan payments. An NOD and Election to Sell is again recorded on instructions from the same beneficiary, but by his use of a different, substitute trustee.

However, the lender does not provide the substitute trustee with the carryback seller's current address. The substitute trustee sends the NOD and Election to Sell, and later the notice of trustee's sales (NOTS), to the carryback seller's old address which was the last address of record. The notices are returned to the trustee by the postal service as undeliverable, and thus are never sent to the carryback seller at his new address.

The carryback seller learns of the NOD and the NOTS during the five business days preceding the date scheduled for the trustee's sale, after expiration of the reinstatement period. The carryback seller seeks to have the substitute trustee rescind the NOD and cancel the trustees's sale, claiming the failure to send him notice of the NOD and NOTS at his address known to the lender invalidates the foreclosure process.

Did the lender properly follow statutory mailing requirements?

No, the lender did not follow the statutory mailing requirements since it did not provide the substitute trustee with the carryback seller's current address. However, the substitute trustee did follow the statutory mailing requirements since he sent notification to the carryback seller at his last address of record. When a beneficiary initiating foreclosure knows an interested party's current address (by correspondence with that address), the beneficiary must ensure the substitute trustee mails the notice to that address.

If the trustee's sale does occur, money losses can be recovered by the junior lienholder from the beneficiary for failure to instruct the substitute trustee to mail the notice to the current address of the junior lienholder as known to the beneficiary. [**I.E. Associates** v. **Safeco Title Insurance Company** (1985) 39 C3d 281]

Documents of record often have outdated or incorrect addresses. However, foreclosure trustees themselves are not required to engage in further efforts to investigate **unrecorded information** to see if the notice is mailed to the most current address for the person entitled to notice. In an effort to protect all interested parties, the trustee should inquire into the beneficiary's knowledge of the current address of parties known to hold interests in the property.

Whenever an owner, carryback seller or tenant has a **change of address**, good practice requires a new Request for NOD to be recorded. When a new Request for NOD is recorded, the trustee foreclosing must send notices to the mailing address given in the new request for notice.

NODq protection

A recorded Request for Notice of Default (NOD) containing a current address assures a carryback seller he will be **sent notice** of the commencement of a trustee's foreclosure sale within 10 days after the NOD is recorded.

However, by the time a senior trust deed lender records an NOD, the loan is often several months in arrears. The amount needed to be advanced by the carryback seller to reinstate the loan may be economically infeasible after a long-standing, continuing default. Delays may occur before an NOD is recorded when lenders are overwhelmed with defaults during recessionary periods. These delays occasionally last a year or more.

Unable or unwilling to reinstate a hugely delinquent first trust deed, the carryback seller loses his second trust deed lien due to the senior lender's foreclosure on the property since it is wiped out, called *exhaustion of the security*.

The Request for Notice of Delinquency (NODq) assures the junior lienholder, who in this scenario is the

carryback seller, that he will be notified when a delinquency in installments has existed for no more than **four months and 15 days**. [CC §2924e(c)]

Good brokerage practice when negotiating a carryback note or a private money loan, secured by a second trust deed, includes the buyer's or owner's consent to use a **Request for Notice** form which includes both the NOD and NODq requests. [See Form 412]

Recording and receiving a Request for NODq

A Request for Notice of Delinquency (NODq) may be recorded and served on a senior lender, if agreed to by a buyer or owner, when the secured property is:

- a one-to-four unit residential property; or
- any other type of real estate, but the senior lender need not respond by giving notice if his original loan was greater than $300,000. [CC §2924e(a)]

A Request for NODq must include the name and address of a carryback seller or private lender as the *requestor*, his security interest in the property as the beneficiary of a trust deed, and identification of the senior trust deed loan.

The buyer or owner must **consent** to the Request for NODq by signing it as the *trustor* before the lender is required to comply with the request. The consent to the Request for NODq should be bargained for as part of the terms negotiated for the carryback note or loan origination. [See **first tuesday** Forms 150 § 8.3 and 426 §7.6]

The written consent of the buyer or owner can be either in a separate document, such as the Request for Notice form, or included with the request in the body of the carryback trust deed. The latter is a complicated alternative since a copy of the trust deed containing the request must then be served on the senior lender. [CC §2924e(a)]

The properly prepared Request for NODq is served on the lender, together with a $40 fee, by regular mail addressed to the lender at the address where loan payments are received.

For example, if the carryback seller is secured by a third trust deed, the first and the second trust deed holders are each entitled to $40 on their receipt of the Request for NODq.

The Request for NODq is prepared, recorded and served on the lender by escrow under instructions from the buyer and the carryback seller. In the case of a loan escrow, the instructions are from the owner and the private lender. All costs to prepare and record the notice are paid by the buyer or owner.

The Request for NODq is **valid for five years** from the date it is mailed to the lender or recorded, whichever event occurs last. [CC §2924e(b)]

Prior to the five-year expiration of the Request for NODq, it may be **renewed** for five additional years by recording and mailing the senior lender a copy of the original Request for NODq, together with a written statement of renewal and a fee of $15. A renewal of the request may be sent no sooner than six months before the expiration date of the five-year period for the original request. [CC §2924e(b)]

Prompted by a Request for NODq from the carryback seller or private lender, the senior lender will send them a notice by regular mail within 15 days following a four month delinquency in the payments of any monies due the lender which remains unpaid. The notice will include the status of the delinquency and the amount required to cure it. [CC §2924e(c)]

Other risk reduction considerations

The Request for NODq scheme, with its four month and 15 day delay before delivery of the notice of any delinquency, provides only limited protection. The carryback seller and private lender must still maintain sufficient **money reserves** for multiple reasons, including:

- to cover future costs and advances required to reinstate the first trust deed on a default by the owner; and
- to carry the payments on the first trust deed (and any delinquent taxes and insurance premiums) until the carryback seller or private lender can complete a foreclosure or pre-foreclosure workout with the owner.

An additional and more fundamental protection for the carryback seller who is subordinated by a senior trust deed lien is to consider the use of an all-inclusive note and trust deed (AITD). As holder of an AITD, the carryback seller, not the buyer, is responsible for the payments on the first trust deed, provided the buyer pays the carryback seller on the AITD. [See **first tuesday** Forms 421, 442, 443 and 450]

When an AITD is used, the need for information on delinquencies in underlying, wrapped loans is reversed between the buyer and the seller. It is now the buyer who needs to make the Request for Notice as the **requestor**. Without making the Request for Notice, the buyer will not receive early notice of a default on the first trust deed if the seller fails to meet his obligations under the AITD to make timely payments on the wrapped loan. The same consideration for an NODq must be given to a tenant's interest under a lease with the owner.

Chapter 6 — Evaluating the carryback note

This chapter presents the rationale of investors who purchase trust deed notes at a discount and the calculations they use to set the discount to produce the yield they desire.

The financial function of a discount

A trust deed investor conducts a due diligence investigation on real estate securing a trust deed note which is for sale. On determining the rate of return he wants if he makes this investment, the investor **calculates the discount** needed to establish the price he would offer to buy the note.

Most trust deed notes offered for sale to trust deed investors are carryback notes created to finance the sale of real estate. Typically, the trust deeds are junior in priority to an existing first trust deed.

A **discount** on the sale of a carryback note will be demanded by investors if it is necessary to deliver the investor a market-level yield. A discount is necessary when carryback paper:

- bears interest at a rate below the private-money market rate;
- has low periodic (monthly) payments based on a long amortization period or has payments of interest only; and
- has a medium- or long-term due date.

The market rate of interest sought by investors in second trust deeds is influenced by the risks of loss and management requirements of a second trust deed investment. The **short-term rates**, influenced by the over-night rate offered by the federal reserve, and **long-term mortgage rates**, influenced by anticipated future inflation, are not the basis used for setting rates charged by second trust deed investors. Second trust deed investors are not concerned or involved with the market which sets the short-term and long-term rates.

Second trust deed investors demand a yield on their investment which is higher than either the current short-term or long-term rate, whether the current rates are high, low, or have inverted themselves. Thus, interest rates in the second trust deed market are higher than the interest rates on typical carryback notes. As a result, investors demand a higher yield than earned on the note's principal at the **note rate** — which leads directly to the discount.

The price a trust deed investor will pay for a note, called the note's *cash value*, moves contrary to the direction of the yield sought by the investor. The more the discount, the lower the price paid for the note, and in turn, the higher the investor's yield.

The discount based on uncertainties

The **cash value** paid by a second trust deed investor to purchase a trust deed note is viewed as a percentage of the principal balance remaining on the note, such as 80% of its *face value*, or a 20% *discount*. [See **first tuesday** Form 241]

The present cash value an investor pays for a note is calculated based on:

- the dollar amount of the regularly scheduled **payments**;
- the **principal balance** remaining and payable as the final/balloon payment on the note's due date; and
- the **yield** sought by the investor on the amount he pays for the note.

The **discount**, of course, is the percentage of the note's principal balance which is not paid to buy the note, such as 20%.

The amount of a discount is influenced by the exposure of the investor's capital to the risk of loss arising out of **uncertainties**, including:

- the inadequacy of the value of the **equity position** in the real estate to fully secure repayment of the note, called the *loan-to-value (LTV) ratio*;
- a delinquent **payment history** on the note;
- **nonrecourse** collection enforcement;
- the lack of **guarantees** or letters of credit;
- unusual terms of the underlying **senior trust deed** loan, taxes or bond assessments which would tend to impair the second trust deed lien;
- the priority of homeowner's association (HOA) assessments or any special assessments;
- questionable **creditworthiness** and unverifiable **net worth** of the owner of the secured real estate; or
- the **occupant's use or rental** of the secured real estate.

Carryback economics affect discount

The amount and terms for payment of a carryback note are influenced by a seller's efforts to **maximize the sales price** of their real estate by agreeing to carry a trust deed note containing:

- a **high loan-to-value (LTV) ratio** for the principal amount of the carryback note, usually due to a small down payment;
- a **low interest rate** which does not compensate for the risk of loss inherent in the highly leveraged carryback note; and
- a **medium-term due date** of four to nine years, or more.

Thus, a carryback note provides attractive financing for buyers. Carryback financing is often offered by a seller to **facilitate the sale** of property when a buyer does not have or is unable to borrow sufficient funds to cash out the sale at the seller's asking price.

As for the financial benefits to a seller, besides ridding himself of his property, a carryback trust deed note contains profit from the sale and produces the financial results of a deferred tax liability on an **installment sale** until the note is paid, sold or hypothecated. [Internal Revenue Code §453; see Chapter 22]

Taxwise, an above-market price for a parcel of real estate and a carryback note with a below-market interest rate and a long-term due date translates, respectively, into:

- **greater profit** to be reported in the future at lower capital gains rates; and
- **lesser interest** income to be reported in the future at higher standard income tax rates.

The savings in reduced overall taxes experienced by deferring the profit tax liability on an enlarged profit and reporting interest income on a below-market rate on the carryback note compensates the seller financially.

Editor's note — The principal amount of the note is subject to ***reallocation*** *to interest under Internal Revenue Service (IRS) imputed reporting rules based on the Applicable Federal Rate (AFR) for the note on the date the purchase agreement is accepted. [See Chapter 21]*

However, while a seller structures carryback terms in order to boost the sales price of the real estate, he is reducing the interest rate on the note. Thus, this trade off presents **drawbacks** for the carryback seller if the note is to be sold or hypothecated.

Loan-to-value leverage considered

The **cash value** of a trust deed note is adversely affected if the equity remaining in a property over and above the amount of the trust deed note is unacceptably small, a risk situation facing a trust deed investor which is referred to as a high *loan-to- value (LTV) ratio*. A prudent investor interested in buying a trust deed secured by a single-family residence will require the secured real estate to have at least a 20% gross equity — over and above the secured position held by the trust deed note offered for sale.

In the event of a default on the note, the cost to foreclose, the amount of cash advanced to carry the senior loan and pay taxes, and the expenses incurred to resell the property will entirely consume (and most likely exceed) an equity smaller than 20% of the property's value. [See **first tuesday** Form 303]

Further, property owners with large equities in their properties are more motivated to keep payments current on the trust deed note than owners with a smaller equity. Thus, an insufficient LTV ratio for a note secured by real estate will require the note to be further discounted to cover the additional risk of loss of the note's principal in the event the trust deed investor will be required to foreclose.

As an alternative, a seller holding a trust deed note on a property with an LTV in excess of 80% should consider obtaining a **collateral loan** secured by the carryback note, rather than selling the carryback note at a drastic discount. By borrowing against the note, the discounting, which would be significant, is entirely avoided.

Discounting the balloon payment note

By using a note's current balance, interest rate, monthly payment schedule, amount of each installment and due date, an investor with a handheld financial calculator can easily establish the *present cash value* (PV) of the note based on the yield — rate of return — sought by the investor on his cash.

Consider an investor who purchases a note with a long-term due date (over nine years). Inflation could rise during the long payoff period causing the **real rate** of return on his invested funds to fall. Thus, the future purchasing power of the principal balance owned on the note has the potential of being eroded by inflation. Also, unforeseeable events in the future may render the secured real estate obsolete or depreciated due to its location, which would impair the value of the note.

The longer the time period for receipt of the note's scheduled installment payments before the due date, the greater the discount and the lower the note's present value, a method of accounting for the increased risk of loss due to inflation and obsolescence. A lender wants compensation for the additional risks which may present themselves while waiting for the return of his principal.

Due to discounts, the actual balloon payment amount on a note is typically greater than the note's present cash value. If the difference is significant, a carryback seller can avoid a discount entirely. Instead of selling the note, the seller can borrow against the note and use it as collateral, called *hypothecation*.

Occasionally, a collateral loan is erroneously labeled as a sale of the note's monthly payments. This type of sale cannot occur, no matter the documentation. Payments cannot be severed and sold separately from the principal of the note since the note is collaterally assigned.

Before calculating the discount to set the price to be paid for a note, an investor must:

- **calculate** the amount of the final/balloon payment due on the note; and
- **set the yield** he wants to receive on his investment in the trust deed note.

Figure 1

The balloon payment on the note is calculated on a standard financial calculator as follows:

- Enter the number of monthly payments [60 N].
- Enter the monthly interest rate [10% g I], or [10/12 I].
- Enter the amount of the note's remaining principal [$60,000 PV].
- Enter the amount of the payment [$600 CHS PMT]. This will be displayed as a negative.
- Request the final/balloon payment of principal due on the note [FV]. $52,256.29 is due with the 60th payment.

Figure 2

Retain the entries from Figure 1 above and make the following substitutions to compute the discount necessary to receive the desired 18% yield:

- Enter the desired yield [18% g I].
- Request the note's present cash value [PV]. The present cash value of the note is $45,016.45.

The balloon payment (Figure 1)

Consider an investor who investigates a carryback note which is offered for sale. The note has a remaining principal balance of $60,000, an interest rate of 10%, monthly payments of $600, and a final/balloon payment due in five years.

Before purchasing the balloon payment note, the investor must establish the amount of the final/balloon payment. The entries in Figure 1 are used to calculate the final/balloon payment. [See Figure 1]

The cash value (Figure 2)

Continuing with our previous example, the investor wants an 18% yield on his investment in the $60,000 trust deed note, not the 10% interest rate provided in the note. The entries in Figure 2 establish the cash value which the investor will offer to pay to acquire the note. [See Figure 2]

Chapter 7 The promissory note

This chapter reviews the types of notes used to evidence debt in financing arrangements which are secured by real estate.

Evidence of carryback debt

Almost all real estate transactions hinge on a buyer financing at least some portion of the purchase price paid for property. That portion of the price financed is evidenced by the buyer's **promise to pay** a sum of money, in installments or by a single lump sum payment at a future time. The financing is provided by either the seller of the real estate or a lender.

The promise to pay, given by the buyer in exchange for property or a loan of money, **creates a debt** owed by the buyer in favor of the seller or lender to whom the promise is made.

Usually, the promise to pay is set out in a written document signed by the buyer, called a *promissory note*. The **promissory note** simply represents a debt owed by one person to another. The signed promissory note is not the debt itself but **evidence** of the existence of the debt.

The buyer, called the *debtor* or *payor*, who incurs the debt under a purchase agreement or loan agreement signs the note and at the time of closing delivers it to the carryback seller or lender, called the *creditor* or *payee*.

The debt can either be secured or unsecured. If the debt is secured by real estate, the *security device* which should always be used to place a lien on property is a trust deed. When secured, the debt is supported by a voluntary lien on the real estate described in the trust deed.

The promissory note

Notes are categorized by the method employed for repayment of the debt:

- installment notes; or
- straight notes.

Installment notes are used to evidence debt obligations with constant periodic repayments in any amount and frequency as determined by negotiations between a buyer and a carryback seller or lender.

Installment notes are structured as one of two varieties:

- interest-included; or
- interest-extra.

Finally, all notes are further distinguished based on their interest rate formulations:

- fixed interest rate notes; and
- variable interest rate notes, commonly called *adjustable rate mortgages* (ARMs).

The interest-included installment note

An interest-included installment note calls for **constant periodic payments** of principal and interest. Each payment contains diametrically varying amounts of principal and interest since the interest in each subsequent payment decreases as principal is paid. [See chapter 9]

Each payment received is first applied to the interest accrued on the remaining principal balance of the debt through the end of the period for which the payment is due, typically monthly. The remainder of the payment is then applied to reduce the principal balance of the debt.

Interest-included installment notes may either:

- be *fully amortized* through constant periodic payments until paid; or
- include a *final/balloon payment* calling for the principal to be due on a specific date after a period of installment payments, called a *due date*. [See **first tuesday** Form 420 §2.3; see Chapter 8]

The interest-extra installment note

Interest-extra installment notes call for a **constant periodic principal payment** on a debt. In addition to the payment of principal, accrued interest is paid either concurrently with each installment of principal or on a different periodic schedule. [See Form 422 accompanying this chapter]

The principal payments typically remain constant from payment to payment, until the principal amount is fully paid or a due date for a **final/balloon payment** occurs. Accordingly, the interest payment decreases following each payment of principal since interest only accrues on the remaining balance. [See Form 422 §1.5]

Thus, unlike an interest-included note, the amount of each scheduled payment of principal and interest on an interest- extra note is not constant from payment to payment. Each payment of principal and interest is for a smaller amount then the previous payment.

For example, a $200,000 note calls for ten annual payments of $20,000 in principal. Interest is payable every third month (quarterly). Thus, the first four quarterly payments of interest are based on the entire original unpaid balance of the interest-extra note.

However, the second year of interest payments will be based on the principal amount remaining after payment of the principal reduction on the first anniversary of the note. To set the amount of each periodic interest payment, recalculation of the accrued interest paid after each principal payment will continue until the last payment of principal is made.

Straight notes as sleepers

Straight notes call for the entire amount of its principal to be paid in a **single lump sum** due at the end of a period of time, for example, five years after the close of escrow or other specific future date. No periodic payments of principal are scheduled, as is the case with installment notes. [See Form 423 accompanying this chapter]

Interest usually **accrues unpaid** until it is due in a lump sum principal installment, a form of financing sometimes referred to as a "sleeper" trust deed. Occasionally, the interest accruing is paid periodically during the term of the straight note, such as quarterly interest-only payments with the principal all due in seven years, a sort of interest-only installment note.

The straight note is typically used by bankers for short-term loans, called *signature loans*, since a banker's short-term note is not usually secured by real estate.

Payment variations to consider

While installment and straight notes are common, variations on the interest rate and repayment schedules contained in the installment and straight notes are included in these notes to meet the specific needs of the lender and borrower. The variations include the:

- adjustable rate note, commonly called an adjustable rate mortgage (ARM);
- graduated payment note (GPM);
- all-inclusive note, commonly called an all-inclusive trust deed (AITD); and
- shared appreciation mortgage (SAM).

Adjustable rate notes (ARMs), as opposed to a fixed-rate note, call for periodic adjustments to the interest rate, the amount of scheduled payments, and the principal amount (when a negative amortization is involved). The interest rate will vary according to a particular index, such as adjustments every six months based on the cost-of-funds index for the 11th District Federal Home Loan Bank (COFI).

Some institutional lenders base their ARM interest rate on the *12-Month Treasury Average* (12-MTA) index. The 12-MTA is an average of the annual yields on U.S. Treasury Securities for the prior 12 months. As an average, the 12-MTA responds more slowly and less dramatically to fluctuations in short-term rates than ARM indexes other than the 12th District cost-of-funds index.

The ARM provides the lender with periodic increases in his **yield** on the principal balance of a loan during periods of rising and cyclically high short-term interest rates. Thus, the lender is able to retain their margin of yield for profitability when their costs of funds rise.

When an upward interest adjustment occurs, the note's **repayment schedule** calls for an increase in the monthly payment to maintain the original amortization period (30 years for example). However, optional loan payment programs often allow for the amount of the first month's payment, which is based on a very low teaser or qualifying rate, to be maintained for up to 60 months while an increase in the interest rate occurs. The result is a longer amortization period, or more likely, an upward adjustment over a short term in the loan's principal balance.

Graduated payment (GPM) provisions are in great demand when interest rates or home prices rise quickly. Thus, fewer buyers are able to currently meet the increased cost of financing home ownership.

A graduated payment schedule allows buyers time to adjust their income and future expenses to begin the eventual amortization of the loan on a 30 year schedule from the date the loan was originated. Typically, a GPM is coupled with a variable interest rate, called a *GPARM* loan or an *option- ARM* loan.

For example, the GPM provision allows low monthly payments on origination of the loan. The payments are gradually increased over the first three to five year period of the life of the loan, until the payment amortizes the loan over the desired number of remaining years.

However, any accrued monthly interest remaining unpaid each month is added as an adjustment to the principal balance on the carryback note, called *negative amortization*. The negative amortization causes

NOTE SECURED BY DEED OF TRUST

Installment Note — Interest Extra

$_______________, dated _____________, 20______, at ____________________________________, California.

1. In installments as herein stated, for value received, I/we, jointly and severally, promise to pay to

1.1 ____, as the Payee, or order,

1.2 at ____,

1.3 the sum of ____ DOLLARS,

1.4 with interest from _____________, 20______, on unpaid principal,

1.5 at the rate of ______% per annum.

2. Interest payable on the _____________ day of each _____________ month,

2.1 beginning on the _____________ day of _____________, 20______.

3. Principal payable in installments of ____DOLLARS, or more,

3.1 on the _______________ day of each _______________ month,

3.2 beginning on the _____________ day of _______________, 20______,

3.3 and continuing until _____________, 20______, when the principal is due and payable.

4. Principal and interest payable in lawful money of the United States.

5. On default in payment of any installment when due, the whole sum of principal and interest may be called immediately due at the option of the Note holder.

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7. In any action to enforce this Note the prevailing party shall receive attorney fees.

8. This Note is secured by a DEED OF TRUST.

9. ☐ See attached Signature Page Addendum. [**ft** Form 251]

Payor's Name: _______________________________	Payor's Name: _______________________________
Signature: __________________________________	Signature: __________________________________
Payor's Name: _______________________________	Payor's Name: _______________________________
Signature: __________________________________	Signature: __________________________________

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the unpaid interest to bear interest as though it was principal, called *compounding*, which is an insidious bargain if home prices fail to rise rapidly, as is usually the case when short-term rates rise.

All-inclusive trust deeds (AITDs) are used more often in carryback transactions than in transactions where money is lent. Lease-option agreements, land sales contracts and AITDs become popular among buyers and sellers in times of economic recession, increasing mortgage rates and tightening the availability of mortgage credit.

Lease-option agreements and land sales contracts are *security devices* which do not use a separate note to evidence the debt owed to a seller. Instead, they contain note provisions which provide evidence of the debt owed to the seller. However, the lease-option and the land sales contract contain greater legal risks than the AITD note, due to their characterization as mortgages if they do not contain trustee foreclosure provisions. In application, the lease option and the land sales contract possess the same financial function and produce the same tax result as the AITD. [See Chapter 15]

The AITD wraparound note typically calls for the buyer to pay the carryback seller constant monthly installments of principal and interest. The carryback seller then pays installments due on the underlying (senior) trust deed note from the payments received on the AITD. [See Chapter 15]

The **shared appreciation mortgage (SAM)** variation is designed to help sellers attract buyers during times of a tightening mortgage money market, prior to a general decline in real estate sales and prices, when many eager buyers are in the real estate market. The SAM is an example of a *split-rate note* and is also called an *appreciation participation* (AP) note. [See **first tuesday** Form 430]

Under a SAM note, the buyer initially pays a fixed interest rate, called a *floor* or *minimum rate*. The floor rate charged is generally two thirds to three fourths of the prevailing market rate, but no less than the *applicable federal rate* (AFR) for reporting imputed interest on the debt. [See Chapter 21]

As a result of the split-rate aspect, the buyer also pays the carryback seller a percentage of the property's appreciated value when the property is resold by the buyer or when the carryback SAM is due, called *contingent interest*.

Financial terms of a note

A note documents the **terms for repayment** of a loan or, on a credit sale, the payment of a portion of the sales price carried back after a down payment, including:

- the amount of the debt;
- the interest rate;
- the periodic (usually monthly) payment schedule; and
- any due date.

The **amount of the note** carried back by a seller on an installment sale of a property is directly influenced by whether the carryback is:

- an all-inclusive trust deed (AITD) note; or
- an equity note.

NOTE SECURED BY DEED OF TRUST

Straight Note

$_______________, dated _____________, 20______, at ____________________________________, California.

1. ____ after date, for value received,

1.1 I/we promise to pay to ____, as the Payee, or order,

1.2 at ____,

1.3 the sum of ____ DOLLARS,

1.4 with interest from _____________, 20________, on unpaid principal,

1.5 at the rate of ______% per annum.

2. Interest payable:

2.1 ☐ with the principal.

2.2 ☐ on the _______ day of each ___________ month, beginning on the _______ day of ___________, 20______.

3. Principal and interest payable in lawful money of the United States.

4. On default in payment of any installment when due, the whole sum of principal and interest may be called immediately due at the option of the Note holder.

5. ____
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6. In any action to enforce this Note, the prevailing party shall receive attorney fees.

7. This Note is secured by a DEED OF TRUST.

8. ☐ See attached Signature Page Addendum. [**ft** Form 251]

Payor's Name: ________________________________	Payor's Name: ________________________________
Signature: ___________________________________	Signature: ___________________________________
Payor's Name: ________________________________	Payor's Name: ________________________________
Signature: ___________________________________	Signature: ___________________________________

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An AITD note carried back by a seller will always be of a greater amount than an equity note in any sales transaction since the AITD note includes the dollar amount of the wrapped loans. Conversely, an equity note only includes the dollar amount of the seller's remaining unpaid equity after deducting the down payment.

Interest rate limitations on loans

California's usury laws limit the interest rate on *non- exempt real estate loans* to the greater of 10% or the discount rate charged by the Federal Reserve Bank of San Francisco, plus 5%. [Calif. Constitution, Article XV]

A non-exempt **loan is usurious** if the promissory note provides for an interest rate (rate of return) which exceeds the ceiling rate on the day the note is entered into.

However, all real estate loans made or arranged by a real estate broker or institutional lender are **exempt** from the usury restriction. [Calif. Const. Art. XV §1]

Seller carryback notes are not loans of money. Instead, they are extensions of credit on the price paid for the real estate and are thus not covered by usury laws. [**Boerner** v. **Colwell Company** (1978) 21 C3d 37]

The trust deed lien as security

In most carryback transactions, a buyer gives a seller a trust deed lien on the real estate sold. Thus, the property provides **security for payment** of the portion of the price remaining to be paid.

The trust deed attaches the debt to the property as a *lien* on the property conveyed to the buyer. The trust deed is recorded to give notice of, and establish priority for, the seller's security interest in the property. [**Monterey S.P. Partnership** v. **W.L. Bangham, Inc.** (1989) 49 C3d 454]

A trust deed without a **monetary obligation** owed to the beneficiary of the trust deed is worthless. Although the note and trust deed executed by a buyer in favor of the seller are separate documents, a trust deed can only exist so long as there is a debt for it to secure, such as an existing promise to pay or perform any lawful act structured as a monetary obligation when a default occurs. [**Domarad** v. **Fisher & Burke, Inc.** (1969) 270 CA2d 543]

Even though the note and trust deed are separate documents, they are used for the same secured loan transaction and constitute contracts to be read together, in tandem, as one. [Calif. Civil Code §1642]

Chapter 8 — Basic provisions in trust deed notes

This chapter analyzes the basic provisions needed in a note for a creditor to enforce a debt.

Minimum elements for enforceability

A **promissory note** with the minimum required provisions describing the amount of the debt, interest rate and repayment schedule is *evidence* of an agreement to pay money. An agreement to pay money on a future date must be **definite** and **certain** in its terms to be enforceable. [See Form 420 accompanying this chapter]

A note secured by a trust deed typically provides for the payment of installments of principal and interest on a debt amortization schedule. The note is used to document the amount of the debt and terms for its repayment. The note also provides a checklist of the minimum fundamental elements of a debt which must be agreed to for it to be enforceable by the creditor or the owner of the property.

The following analysis and instructions are for the preparation and use of Form 420, an installment note providing for periodic payments of principal and interest. Form 420 is designed for brokers, their agents and escrow officers to document a debt previously agreed to in a purchase agreement, loan agreement or escrow instructions.

The note is prepared concurrent with the preparation of the trust deed used to impose a lien on the real estate for the amount of the debt evidenced in the note. The note will be signed by the debtors, such as the buyers or owners of the real estate which will secure the debt.

The numbers on the instructions correspond to the numbers given provisions in Form 420.

Identification of the note

The **dollar amount** of the note is entered at the top left corner of the note and is for identification purposes only.

The actual **principal amount** of the debt to be paid appears in the body of the note at §1.3, or in an *allonge*. The amount of the principal debt may be different from the dollar amount entered to identify the note, due primarily to adjustments and prorations at the close of escrow which may alter the amount initially set as the debt.

The dollar amount entered at the top of the note for identification purposes is also entered in the trust deed to cross reference the debt secured by the real estate described in the trust deed.

The **date** the note is prepared is entered at the top of the note for identification purposes only.

Consider a trust deed securing a debt which makes reference to a promissory note "of same date" to the identification date in the trust deed. In this scenario, the identification dates in the note and its trust deed must correspond to each other.

However, if the trust deed is not given the same date as the identification date for an existing note, the words "same date" should be **stricken** from the trust deed and the date of the note should be entered

to identify the note secured by the trust deed, an activity called *interlineation*. [See **first tuesday** Form 450]

The **location** where the note is prepared is also entered at the top of the note, again for identification purposes only. The location of preparation may differ from the place the payments on the debt are to be made as called for in §1.2.

The entries for the dollar amount, date and city are used when referencing the note.

1. Consideration for the note

The person signing the note, called the *debtor*, must receive something of value in exchange for his promise to pay contained in the note. Generally, the consideration for the promise to pay is money lent or property sold on credit to the buyer.

The words "for value received' establish the buyer's **receipt of consideration** given by the lender (in the form of money) or carryback seller (in the form of property) in exchange for the buyer's promise to pay. A promissory note is unenforceable by its holder unless consideration is given to the buyer or borrower in exchange for executing the note. [**Doria** v. **International Union, Allied Industrial Workers of America, AFL-CIO** (1961) 196 CA2d 22]

The buyer **promises to pay** the debt owed to the lender or carryback seller according to the terms for repayment *memorialized* in the note, on an installment basis which often includes a lump sum as a final/ balloon payment.

An *unconditional promise to pay* is essential for the note to be negotiable by the carryback seller. The note must be negotiable if the seller is to sell or borrow against (*hypothecate*) the note and trust deed. [Calif. Commercial Code §3104]

However, the buyer's promise to pay on a note secured by a trust deed is not always enforceable against him personally. On a nonrecourse, *purchase-money* loan or a carryback note, the promise to pay money is not enforceable by way of a money judgment against the buyer. [See Chapter 17]

1.1 — Identification of creditor as payee

The **unconditional promise to pay** must be made to a specific person or persons, whether the person is an individual or an entity, called the *creditor* and entitled the *payee*.

The **name of the lender** or carryback seller as creditor must be entered in the note for it to be enforceable, unless their identity is apparent from the conduct of the parties. Unlike a check, the name of the lender or carryback seller cannot be left blank. [**Schweitzer** v. **Bank of America N. T. & S. A.** (1941) 42 CA2d 536]

The words "or order" immediately following the name of the creditor (the lender or carryback seller) allow the creditor to *assign the note*.

The buyer not only promises to pay the creditor, but the words "or order" extends this promise to whomever the creditor **assigns the note**.

The "or order" provision also allows the creditor to designate someone to collect payments and service the note on the creditor's behalf, called *contract collection*.

NOTE SECURED BY DEED OF TRUST
Installment — Interest Included

$_______________, dated _____________, 20______, at ____, California.

1. In installments, for value received, I, jointly and severally, promise to pay to

1.1 ____, as the Payee, or order,

1.2 at ____,

1.3 the sum of ____ DOLLARS,

1.4 with interest from _____________, 20______, on unpaid principal,

1.5 at the rate of ______% per annum.

2. Principal and interest payable in installments of _____________________________________ DOLLARS, or more,

2.1 on the _______________ day of each _______________ month,

2.2 beginning on the _______________ day of _____________, 20______,

2.3 and continuing until _____________, 20______, when the principal is due and payable.

2.4 Principal and interest payable in lawful money of the United States.

2.5 Each payment shall be credited first on interest then due and the remainder on principal.

3. On default in payment of any installment when due, the whole sum of principal and interest may be called immediately due at the option of the Note holder.

4. ____
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5. In any action to enforce this Note, the prevailing party shall receive attorney fees.

6. This Note is secured by a DEED OF TRUST.

Payor's Name: ________________________________	Payor's Name: ________________________________
Signature: ____________________________________	Signature: ____________________________________
Payor's Name: ________________________________	Payor's Name: ________________________________
Signature: ____________________________________	Signature: ____________________________________

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1.2 — Place of payment

The note must specify the place where payment is to be made, usually the city or county in which the creditor lives or does business.

If the note is not clear as to the place of performance — delivery of the payments — the location of the creditor is the appropriate place for performance.

The place of performance is important since it determines the proper court for any litigation between the parties, called *venue*, should the note be unsecured and in default, or be a recourse note secured by a trust deed which has been wiped out by the foreclosure of a senior trust deed holder.

If a lawsuit involves the secured real estate, such as a judicial foreclosure, the location of the real estate, called *situs*, determines the county where the action will be filed. [California Code of Civil Procedure §392]

However, if the action only involves a dispute over the terms of the note, not the trust deed, then the place of performance or the location of the carryback seller would be a proper venue. [**Dawson** v. **Goff** (1954) 43 C2d 310]

1.3 — The amount of the principal debt

Unless the dollar amount of the **original debt** is entered in the body of the note, the note will be unenforceable due to the uncertainty of the amount due. Also, a note which does not specify the dollar amount of the debt is nonnegotiable. [Com C §3104]

The principal amount of the debt which is entered in the body of the note, like the amount identifying the note, is not necessarily the actual amount of the original debt.

Often, the actual principal amount of the debt differs from the dollar amount stated in the note, due to adjustments and prorates in the sales escrow creating the note.

The actual principal amount of the debt is often entered on the back of the note as an endorsement or attached to the note in an *allonge* at the close of escrow.

Generally, escrow is handed a note which has been signed before the note amount is entered, together with instructions to enter the actual principal amount of the debt on closing.

1.4 — Interest accrual commencement date

Here, the note specifies the date interest begins to accrue on the principal debt. A rate of interest is not required to make a note enforceable.

Usually, interest begins to accrue on the date escrow closes. However, at the time the note is prepared, the date escrow will actually close is yet unknown.

If the exact date interest is to begin to accrue is unknown, the space for the accrual date is left blank when the note is prepared. Escrow is then instructed to fill in the date when closing occurs, or correct the date by **endorsement** or an **allonge**.

1.5 — The interest provision

The note specifies the annual interest rate charged by the lender or carryback seller.

If an interest rate is not called for in the note, interest will accrue at the legal rate (10%) after the due date for payment of the principal. [**Bank of United States** v. **Foreman** (1929) 102 CA 756]

A lender or a carryback seller is not required to charge any rate of interest at all, in which case the rate of interest would be entered as zero. However, the seller must be aware he will report interest at an *imputed rate*, the applicable federal rate (AFR) for the note, when he charges a rate less than the AFR. When interest is **imputed**, the principal amount of the note is reduced and allocated to interest for the seller's tax reporting purposes only. [Internal Revenue Code §483; see Chapter 21]

Also, instead of a fixed rate of interest, the parties may agree to a different method of figuring interest, such as an adjustable rate mortgage (ARM) or a shared appreciation at maturity (SAM) note.

2 — Installment provision

Here, the dollar amount of each installment of principal and interest is entered on the note.

Only the constant regular installments are stated in the body of the note. Additional amounts of principal only payments, accrued and unpaid interest, or balloon payments are entered elsewhere on the face of the note.

By the terms of the note, the borrower or buyer promises to pay installments in the amount stated, "or more."

The "or more" clause, unless deleted or restricted by the entry of other provisions, allows the buyer to prepay a portion or all of the debt at any time by making principal payments larger than the amount of periodic installments. Other provisions in the note may bar the use of the "or more" clause, or place a dollar penalty on additional principal payments which are paid as allowed by the clause.

The lender can charge and enforce a dollar penalty for early payment of principal, within statutory and case law limitations on penalty amounts, if the penalty is provided for in the note.

The lender or carryback seller may negotiate a deletion of the words "or more" to prohibit the buyer from prepaying the note in some situations. Thus, the buyer is **locked into paying only** the agreed-to installments.

2.1 — Time of payment

In this section of the note, the day of the month a payment will be due and the period between the payment of installments are entered.

The installment period establishes the frequency of payments and is defined by the number of one or more months separating these payments.

Installment payments are typically due on a monthly basis, payable on the first day of each consecutive month. Thus, the payment period entered on the note is "consecutive" if the installments are due every month. If they are due every other month, the period entered is "second", or "third" if due quarterly, etc.

A payment becomes delinquent the day after its due date, unless a *grace period* exists as provided by statute or by agreement. A **grace period** extends the time after the due date for the lender or carryback seller to **actually receive** the payment before it becomes delinquent and a late charge is assessed or foreclosure commenced.

2.2 — First payment date

The date the payment of installments is to begin is entered on the note in this section. Often, the date of the first payment is 30 days after escrow closes. Alternatively, the commencement of payments could be the first day of the month first following 30 days after the close of escrow, in which case escrow should be instructed to credit the seller with interest which will accrue through the end of the month of closing.

2.3 — Date of final payment

Installment payments are to continue until the note is due or paid in full.

Unless prior agreements call for a final/balloon payment, the note should read: "*and continuing until paid"*, with the word "paid" being entered in the space provided for a date. If a final/balloon payment has been agreed to, enter the date of its payment. Often the due date is set as a fixed period of years after the close of escrow, in which case escrow will be instructed to enter the date of this anniversary when the date is known to escrow.

2.4 — Form of payment

All payments made on a promissory note entered into in the United States, unless agreed to the contrary, are to be made in United States currency, either cash, check, money order or cashier's check. If an off-shore currency or other medium of exchange (such as gold) is to be used, the note must provide for it.

2.5 — Interest accrual

The note provides for installment payments to be credited first toward interest accrued and then to principal, called an *accrual note*.

On an **accrual note**, interest is charged only on *unpaid* principal. Interest is calculated and paid periodically after the interest has been earned. Interest is not prepaid by the terms of an accrual note.

An accrual note differs from an *add-on note*. Interest on an **add-on note** is charged on the original loan amount for the entire term of the loan. The entire amount of interest is added to the original loan amount to set the total amount of principal and interest to be paid on the note. Computation of interest amounts and principal payoffs on add-on notes are controlled by the Rule of 78.

3 — Default provision

The failure of the borrower or buyer to timely pay an installment on the note allows the note holder to declare the note due, called *acceleration*.

The right to accelerate the loan balance is exercised by calling the principal due. Acceleration does not operate automatically on the occurrence of a triggering event, such as a default. Thus, the holder of the carryback note must act to call the loan by making a demand on the property owner to pay all sums due. [**Green** v. **Carlstrom** (1963) 212 CA2d 240]

However, a properly executed call is unenforceable until after a foreclosure has been commenced and the reinstatement period has expired, except in the case of an incurable breach, such as an acceleration under a due-on clause or waste provision. If the debt is secured by a trust deed on real estate, the owner of the real estate has up to five business days before the trustee's sale to cure the default by bringing the loan current and paying the authorized costs of foreclosure, called *reinstatement* of the loan. [Calif. Civil Code §2924c]

A similar **reinstatement** right exists for notes secured by mobilehomes and automobiles. [CC §2983.3; Calif. Health and Safety Code §18037.5]

However, when the note is secured solely by a security interest in personal property other than a mobilehome or automobile, the lender can accelerate the entire balance due on any default. The terms of the note allowing the personal property lender (except in the instance of mobilehomes and automobiles) to call do not permit a reinstatement of the note and no statutory right to a reinstatement period exists. [Com C §9623]

Further, when the note is **unsecured**, the option to accelerate is not restricted. Any reinstatement permitted must be voluntarily agreed to by the holder of the note. [**Messner** v. **Mallory** (1951) 107 CA2d 377]

4 — Additional provisions

Optional provisions for inclusion in the promissory note may be negotiated in purchase agreements and escrow instructions, such as:

- additional principal payments;
- a prepayment penalty;
- late charges and grace periods;
- compounding on a default;
- a balloon payment notice;
- extension of the due date;
- an option for a payoff discount;
- the right of first refusal on the sale of the note;
- reference to a guarantor;
- an exculpatory clause; and
- governing law. [See Chapter 10]

An all-inclusive provision is added to the note when the remaining balance of any encumbrance on the secured real estate is included in the principal of the carryback note and remains the responsibility of the seller to pay, called an all-inclusive trust deed (AITD) note. [See Chapter 15]

5 — Attorney fees

The note includes a promise to pay attorney fees if legal action is necessary to enforce or interpret the note.

Although the wording in some attorney fees provisions may appear to be one-sided against the borrower, California law automatically makes the recovery of attorney fees *reciprocal*. Thus, if the borrower is the winning party in litigation on the note and trust deed, he will recover his legal fees from the holder of the note, even though the holder may never have promised to pay attorney fees. [CC §1717]

The attorney fees provision applies not only to the original borrower and lender or carryback seller, but also to their grantees and assignees. For example, a buyer who acquires property subject to an existing loan without entering into a loan assumption agreement is not a party to the loan. However, he can collect legal fees in a successful lawsuit against the lender regarding the note and trust deed since the lender would be able to collect its attorney fees if it prevailed. [**Saucedo** v. **Mercury Savings and Loan Association** (1980) 111 CA3d 309]

Additionally, the attorney fees provision permits the prevailing party to recover their attorney fees even if the note and trust deed are declared void or unenforceable. [**Manier** v. **Anaheim Business Center Company** (1984) 161 CA3d 503]

6 — Identification of security

The note states the debt is secured by a deed of trust. However, neither the trustee under the trust deed nor the real estate which is the security need to be identified. The link-up is made through the trust deed reference to a note of the same date with a corresponding stated amount due to the beneficiary as payee.

7 — Borrower identification and signature

At the bottom of the note, the borrower or the buyer, also known as *debtor, payor, obligor* or *trustor*, signs and thus identifies himself as the person promising to pay money to the creditor, whether the creditor is a lender or a carryback seller.

Neither the lender nor the carryback seller signs the note or the companion trust deed.

Chapter 9 — Special provisions for a promissory note

This chapter presents provisions which may be included in a promissory note, in addition to basic provisions in regular forms.

Beyond fundamental debt obligations

A *promissory note* contains a buyer's **promise to pay** a private lender or carryback seller the principal amount agreed to, plus any interest. The note is **evidence** the debt exists.

The schedule and conditions for payment of the principal and interest are also contained in the note.

In contrast, provisions in a *trust deed*, besides referencing the note and describing the real estate liened to secure the debt, primarily address the **maintenance and preservation** of the noteholder's *security interest* in the real estate.

Special provisions added to a note serve to:

- **protect** the noteholder against risk of loss due to late payments, early payoff or other defaults on the note; and
- **comply** with statutorily mandated provisions for controlled transactions.

Special provisions to be considered for inclusion in a **promissory note** include:

- grace period and late charges [see **first tuesday** Form 418-1];
- compounding on default ;
- a prepayment penalty [see **first tuesday** Form 418-2];
- balloon payment notice [see **first tuesday** Form 418-3];
- option for payoff discount;
- right of first refusal on sale on the note [see **first tuesday** Form 418-4];
- due date extension;
- reference to a guarantor [see **first tuesday** Form 418-5];
- exculpatory clause [see **first tuesday** Form 418-5]; and
- governing law. [see **first tuesday** Form 418-5]

Should there not be ample room on the face of the note to enter the special provisions, enter a reference to an addendum as containing provisions which are part of the note. Then prepare and attach an addendum with a staple to the note, called an *allonge*.

Prepayment penalties for tax's sake

A prepayment penalty is an extra charge incurred to pay off principal on a note before the principal is due by the terms of the note. [See Chapter 8]

A prepayment penalty is enforceable if it is reasonably related to money losses suffered by a private lender or carryback seller, such as the payment of profit taxes incurred by a carryback seller on a premature reduction in principal or final payoff. [**Williams** v. **Fassler** (1980) 110 CA3d 7]

The amount of the prepayment penalty the private lender or carryback seller can charge depends on:

- the **type** of property; and
- the owner's **use** of the property.

A prepayment penalty on a note secured by an owner-occupied, one- to-four unit residential property, when more than 20% of the original amount of the note is prepaid in any 12-month period, is limited to no more than six months' advance interest on the principal reduction in excess of 20% of the original balance. [See Figure 1 §1; see **first tuesday** Form 418-2]

The prepayment penalty on a note secured by an owner-occupied, one- to-four unit residential property may only be charged in the first five years of the note. **After five years**, the note can be prepaid without a penalty. [Calif. Civil Code §2954.9(b)]

Figure 1

Prepayment penalty note provisions

[**first tuesday** Form 418-2 §§2.1-2.3]

1. *For owner-occupied, one-to-four residential units:*

□ If Payor voluntarily or involuntarily pays in any 12-month period within five years after origination an amount in excess of 20% of the original principal amount of the note before it is due, a prepayment penalty is due, on demand, in the amount of six months' advance interest on the amount prepaid in excess of 20% of the original principal balance amount, except as prohibited by law on the use of any due-on clause.

2. *For broker-made/-arranged loans on owner-occupied, single family residences [Calif. Business and Professions Code §10242.6(a)]:*

□ If Payor voluntarily or involuntarily pays in any 12-month period within seven years after origination an amount in excess of 20% of the remaining principal amount of the note before it is due, a prepayment penalty is due, on demand, in the amount of six months' advance interest on the amount prepaid in excess of 20% of the remaining principal balance, except as prohibited by law on the use of any due-on clause.

3. *On all other residential and nonresidential property:*

□ If all or part of the principal is paid, voluntarily or involuntarily, before it is due, a prepayment penalty is due, on demand, in the amount of ______% of the principal prepaid in excess of the principal included in the regularly scheduled payments, except as prohibited by law on the use of any due-on clause.

On a broker-made or-arranged loan originated by a private lender and secured by an owner-occupied, single family residence (SFR), up to 20% of the remaining principal balance may be prepaid in any 12-month period without penalty.

The penalty on broker-made or-arranged loans for any prepaid principal exceeding 20% of the remaining balance is limited to six months' advance interest on the excess principal reduction. The penalty may be imposed for up to **seven years** after origination of the loan. [Calif. Business and Professions §10242.6; see Figure 1 §2; see **first tuesday** Form 418-2]

On notes secured by other than owner-occupied, one-to-four residential units, the noteholder may charge a prepayment penalty limited in amount and time only by reasonableness.

However, if the noteholder intends to collect a prepayment penalty should he ever call the note under due-on clause in his trust deed (excluding one-to-four unit residential property), the borrower must separately sign or initial any prepayment penalty provision which includes a waiver of his right to prepay without a penalty. [CC §2954.10; see Figure 1 §3; see **first tuesday** Form 418-2]

Figure 2

Late charge provisions

[**first tuesday** Form 418-1 §§2.1-2.5]

1. *For an owner-occupied, single family residence:*

□ Any installment on this note not received within 10 days after the due date is delinquent and will incur a late charge, on demand, in the sum of 6% of the delinquent principal and interest installment amount.

2. *For a broker-made/-arranged loan on any property [Calif. Business and Professions Code §10242.5(a)]:*

□ Any installment on this note not received within 10 days of the due date is delinquent and will incur a late charge, on demand, in the sum of 10% of the delinquent principal and interest installment amount.

3. *On other than owner-occupied, single family residences or broker-made/-arranged loans:*

□ If any installment on this note is not received when due, or within ______ days of the due date, the installment will be delinquent and will incur a late charge, on demand, in the sum of $________________, or ______% of the delinquent principal and interest installment amount.

4. *For a broker-made/-arranged loan on any property, final/balloon payment late charge [Calif. Business and Professions Code §10242.5(c)]:*

□ If the final/balloon payment due on this note is not received within 10 days after the due date, the final/balloon payment will be delinquent and will incur a late charge on the delinquency and thereafter, on demand, for each month the final/balloon payment remains unpaid. The late charge will be the sum of 10% of the largest scheduled monthly installment on the Note.

5. *For a balloon payment late charge on other than owner-occupied, single family residences or broker-made/-arranged loans:*

□ If the final/balloon payment is not paid by the due date, the remaining principal balance will thereafter accrue at the rate of ______%.

Late charges and grace periods

A late charge provision in a trust deed note usually imposes an additional one-time fee or interest accrual on the amount of the delinquent payment.

On notes secured by real estate, except a note secured by an owner- occupied single family residence (SFR) or a loan made or arranged by a broker and secured by any type of property, the **late charge** for the delinquent payment of an installment must be an amount **reasonably related** to:

- the private lender's or carryback seller's actual out-of-pocket losses incurred in preforeclosure collection efforts; or
- the value of the lost use of the delinquent funds. [CC §1671; see Figure 2 §4; see **first tuesday** Form 418-1]

A typical late charge provision takes the form of a flat fee or a percentage of the monthly installment or note balance.

However, a late charge provision in a note specifying an increased interest rate on the **entire remaining principal** on default of any monthly installment, called a *default interest rate*, is unenforceable as a disguised penalty provision.

A penalty provision is **void** if it fails to reasonably estimate compensation for the lender's losses caused by the default. The rate of interest on a default can only be applied to the delinquent principal and interest payment since only an installment is delinquent, not the entire principal balance of the note. [**Garrett** v. **Coast and Southern Federal Savings and Loan Association** (1973) 9 C3d 731]

The amount of a late charge on any note secured by an owner- occupied SFR is limited to the greater of:

- 6% of the delinquent principal and interest installment; or
- $5. [CC §2954.4; See Figure 2 §1; see **first tuesday** Form 418-1]

For loans made or arranged by a real estate broker and secured by any type of real estate, a late charge is limited to the greater of:

- 10% of the delinquent principal and interest payment; or
- $5. [Bus & P C §10242.5(a); see Figure 2 §2; see **first tuesday** Form 418-1]

Figure 3

Compounding interest on a default

[**first tuesday** Form 418-1 §2.6]

□ On default in the payment of a principal and interest installment when due, the unpaid interest will be added to the remaining principal balance and accrue interest at the same rate as the principal debt until the delinquent payment and the accrued interest on the delinquent interest are received.

A default on the balloon payment

Also, if the broker-arranged loan contains a due date for a **balloon payment**, a late charge may be assessed if the balloon payment is not received within ten days after the due date.

The maximum enforceable late charge for a delinquent balloon payment on a broker-made or-arranged loan secured by any type of property, and for each following month the balloon payment remains unpaid, is an amount equal to the maximum late charge imposed on the **largest installment payment scheduled** in the note. [Bus & P C §10242.5(c); see Figure 2 §3; see **first tuesday** Form 418-1]

On all installment sales, except on an owner-occupied SFR, an **increased interest rate** on the remaining principal, triggered by a delinquency of the final/balloon payment, is an acceptable late charge provision. [**Southwest Concrete Products** v. **Gosh Construction Corporation** (1990) 51 C3d 701; see Figure 2 §5; see **first tuesday** Form 418-1]

However, as a late charge, any increased interest rate triggered by a delinquency is still controlled by reasonableness. [Garrett, *supra*]

For carryback SFR notes and broker-made or-arranged loans, an installment is not late if paid within ten days after the installment is due, called a *statutory grace period*. [CC §2954.4; Bus & P C §10242.5]

Also, on an SFR note or broker-made or-arranged loan, the private lender or carryback seller cannot charge more than one late charge per delinquent monthly installment payment — no matter how long the payment remains delinquent. [CC §2954.4(a); Bus & P C §10242.5(b)]

Compounding interest on default

A *compounding-on-default interest provision* is triggered by a delinquency in a payment. Compounding causes interest to accrue on the interest contained in the delinquent installment at the note rate until the delinquent payment and compounded interest are paid. [See Figure 3]

Figure 4

Balloon payment notice provision [**first tuesday** Form 418-3 §2.1]

□ This note is subject to Calif. Civil Code §2966, which provides that the holder of this note shall give written notice to Trustor, or his successor(s) in interest, of prescribed information at least 90 and not more than 150 days before any final/balloon payment is due.

Figure 5

Due date extension provision [**first tuesday** Form 418-3 §2.2]

□ The due date will be extended for ______ year(s) if all monthly installments due within ______ month(s)

Figure 6

Discount for early payoff provision [**first tuesday** Form 418-2 §2.4]

□ Payor is hereby granted the irrevocable right to purchase or pay off and fully satisfy the note on payment of the sum equal to the principal remaining unpaid less a ______% discount, plus accrued interest and future advances, for the period expiring ____________, 20______.

Compounding interest provisions are used in lieu of flat fee or percentage late charge provisions.

Under a compounding interest provision, the reinstatement amount includes the delinquent principal and interest payment plus the additional compounded interest.

A compounding interest provision is a type of **late charge** since it penalizes the borrower and is triggered by a delinquency in a payment, although no case or statute defines it as such.

As a late charge, the limitations on amounts and grace periods for late charges apply to the enforcement of provisions calling for compounding on default.

Balloon payment notice

A balloon payment is a final lump sum payment of remaining unpaid principal, which is due on an earlier date than had the periodic payment schedule continued until the principal was fully amortized.

A **balloon payment note** secured by owner-occupied, one-to- four unit residential property is a note which contains provisions for:

- a *final payment* which is more than twice the amount of any of the six regularly scheduled payments preceding the date of the balloon payment; or
- a *call provision*. [CC §2924i(d), §§2957(b), 2957(c)]

A **call provision** gives the private lender or carryback seller the right to demand final payment at any time after a specified period.

All balloon payment notes secured by one-to-four unit residential property must include a reference to the buyer's right to receive a *balloon payment notice* 90 to 150 days before the due date. [CC §§2924i, 2966; see Figure 4; see **first tuesday** Form 418-3]

Failure to include the balloon payment notice provision in the note will not invalidate the note, but

Figure 7

Right of first refusal provision

[**first tuesday** Form 418-4 §§3-5]

Payee hereby grants Payor a right of first refusal to purchase the Note and Trust Deed.

Should Payee decide to sell an interest in the Note and Trust Deed, Payee shall notify Payor of the terms on which Payee is willing to sell and assign the Note and Trust Deed.

Payor has the option, for a period of _____ days after receiving notice, to purchase the Note and Trust Deed on the terms stated in the notice.

Should Payor fail to exercise the option within the option period, Payee has the right to sell the Note and Trust Deed to a third party on the same terms stated in the notice to Payor.

Any sale on different terms reinstates the right of first refusal.

If the Note and Trust Deed is not sold and assigned within six months after Payor's receipt of notice, the right of first refusal is reinstated.

Figure 8

Guarantee provision

[**first tuesday** Form 418-5 §2.1]

□ The Note is guaranteed by ______________________________, under a Guarantee Agreement dated ________________, 20______, at _____________________, California. [See **ft** Form 439]

Figure 9

Exculpatory provision

[**first tuesday** Form 418-5 §2.2]

□ Enforcement of the Note and Trust Deed is subject to the purchase money anti-deficiency provisions of California Code of Civil Procedure §580b.

Figure 10

Governing law provision

[**first tuesday** Form 418-5 §2.3]

□ This Note will be governed by California law.

enforcement of the note's balloon payment provision is still subject to the notice requirements. [CC §2966(d); see **first tuesday** Form 419]

Extension of due date

A provision may grant the buyer an extension of the due date for a **final/balloon payment** conditioned, for example, on the payment of all scheduled installments without delinquency, or on other consideration, such as a charge or change of terms. [See Figure 5]

An agreement to extend the due date in a carryback note should be considered by a buyer when the term of the note is for a short period of time and the buyer is uncertain about the source and availability of funds for payoff.

Discount for early payoff

A buyer's right to pay off the note early is usually documented in the form of an option to buy the note at a discount. [See Figure 6; see **first tuesday** Form 418-2 §2.4]

A carryback seller who prefers to be cashed out before the due date on his trust deed note could include a discount provision to encourage the buyer to pay off the note within a lesser time period than the due date period. The provision can be structured to give the buyer several months to exercise the option to pay off the debt at a discount on the face value (or remaining balance) of the note.

By exercising the option, the buyer who executed the note is buying the note and trust deed from the seller by an assignment.

Right of first refusal to buy note

When the noteholder decides to sell the note, a *right of first refusal* provision contained in them note or a

separate agreement allows the buyer of the secured real estate to purchase or pay off the note. [See Figure 7; see **first tuesday** Form 418-4]

If the noteholder decides to sell the trust deed note, the buyer is notified of the amount necessary for payoff.

The **payoff amount** will be the sales price of the note and is set based on either:

- the noteholder's listing of the trust deed note for sale, or their offer to sell the note; or
- an offer from an investor to purchase the note, which, if accepted, must be accepted contingent on the buyer's exercise of the right to pay off the note.

The buyer, to exercise the right of first refusal, must then match the price.

However, when granting the right of first refusal, the noteholder must be careful not to set the price in advance by stating a price in the right of first refusal provision.

If the payoff amount is set by a prior agreement, the seller is bound by the amount, even if market conditions allow for a higher value when the seller decides to sell the note.

Guarantor

To protect the private lender or carryback seller from loss due to a default on his trust deed note, the private lender or seller may require a third party with sufficient assets to become *liable on call* for all amounts due under the note and trust deed. By guaranteeing the note, a guarantor literally agrees to buy the note from the private lender or carryback seller, called *subrogation* or *equitable assignment*.

The private lender or carryback seller has three types of third party assurances:

- a co-owner's signature on the note and trust deed;
- a co-signer's signature on the note only; or
- a personal guarantee of the note by one other than the buyer.

When a third party signs the note, the third party becomes **liable for repayment** of the note, subject to anti-deficiency rules protecting co-owners on any type of foreclosures and co- signers on trustee's foreclosures. [California Code of Civil Procedure §580b]

However, if a third party agrees to guarantee the note and trust deed, a **guarantee agreement** is signed by the third party and is **enforceable separately** from the note and trust deed. [See **first tuesday** Form 439]

If the note is guaranteed, a provision may be included in the note to reference the separate guarantee agreement. [See Figure 8; see **first tuesday** Form 418-5 §2.1]

By referencing the separate guarantee agreement in the note, everyone is on notice of the additional security for the note provided by the guarantee.

Exculpatory clause

An *exculpatory clause* in a note converts a lender's recourse paper into nonrecourse paper. Conversely, recourse paper is created when the note carried back by a seller is either separately or additionally secured by property other than the property sold. [See Figure 9; see **first tuesday** Form 418-5 §1.4]

When an exculpatory clause is included in a cross-collateralized note (two or more properties are described as the security), neither the private lender nor the carryback seller can obtain a money judgment for any deficiency on a judicial foreclosure of the secured property. Thus, the note has agreed-to anti-deficiency protection. [See Chapter 19; see **first tuesday** Form 418-5 §2.2]

Governing law

A private lender or carryback seller involved in negotiating a carryback sale with an out-of-state buyer must include a *choice-of-law* provision to assure judgments arising from disputes on the note will be based on California law. [See Figure 10; see **first tuesday** Form 418-5 §2.3]

Property taxes and insurance premiums

An impound account provision is included in the trust deed by way of an addendum. With an impound account, the security for the debt will remain unimpaired by defaults in taxes, assessments, and insurance premiums should the beneficiaries have to initiate foreclosure to enforce collection of the principal debt. [See **first tuesday** Form 455]

The owner's payment of taxes and insurance premiums before they become delinquent is required by the trust deed, even if the trust deed does not include an impound account provision to accumulate funds in advance for the payment of taxes and insurance premiums.

By establishing an impound account, the owner must monthly prepay a prorata share of taxes and insurance premiums to the trust deed beneficiary, whether the beneficiary is a lender or a carryback seller. Impounds are amounts paid in addition to the regular monthly installment of principal and interest due on the note.

The beneficiary receives the taxes and insurance payments and holds them in an impound account, also called an *escrow account*. The accumulated funds are disbursed by the beneficiary when the taxes or premiums become due.

A lender or carryback seller secured by a trust deed on an **owner-occupied** single family residence (SFR) can only require the owner or buyer to agree to an impound account if:

- the combined principal amount of two or more notes secured by the real estate is 80% or more of the real estate's appraised value;
- the note amount is 90% or more of the appraised value of the real estate;
- the owner becomes delinquent on two consecutive property tax installments;
- the impound account is required by a state or federal agency; or
- the loan is made, guaranteed, or insured by a state or federal governmental lender or insurer. [CC §2954(a)]

For SFR situations where a beneficiary cannot require an impound account, the owner of the SFR may **agree** to an impound account. However, prior to the execution of the loan documents, carryback note and trust deed, the beneficiary must give the owner a written **impound account disclosure statement** notifying the owner:

- the impound account cannot be required as a condition to the funding of the loan or carrying paper; and
- whether or not interest will be paid on the funds held in the impound account. [CC §2954(a); see **first tuesday** Form 455-1]

Impound payment requirements

When provisions in a trust deed encumbering any type of real estate establish an impound account calling for taxes and insurance premiums, the **beneficiary must**:

- set the amount of the **initial deposit** and **monthly payments** to be made into the impound account — the amounts must be reasonably necessary to accumulate sufficient funds to pay the property taxes, assessments and insurance premiums when due; and
- from the funds received, pay property taxes before they are delinquent and insurance policy premiums before the policy is canceled. [CC §2954.1; see **first tuesday** Forms 455 and 455-1]

The **initial deposit** in an impound account on a note secured by any type of real estate, whether a loan or a carryback, is capped at:

- the total dollar amount of payments for taxes and insurance premiums prorated for the period running from the date their payment was last due to the date of the first installment due on the note; plus
- a reserve of one sixth of the total dollar amount of payments due for the period running from the date the last payments for property taxes and insurance premiums were due to the date of the first payment under the note.

Further, the **monthly impound payments** for an impound account on a note secured by any type of real estate are capped at:

- one twelfth of the estimated annual payments for taxes and insurance; plus
- any deficiency in the reserve of one sixth of the total annual payments for property taxes and insurance premiums. [CC §2954.1(a); 12 United States Code §2609]

Annual accounting by the seller

A seller carrying back a note and trust deed on one- to-four unit residential property with an impound provision must provide the buyer with an **annual impound accounting** within 60 days after the end of each calendar year. [CC §2954.2]

The annual impound accounting must itemize:

- the amount received and applied to interest and principal;
- money received and disbursed from the impound account for the payment of property taxes, bond assessments and insurance premiums; and
- any late charges. [CC §2954.2(a)]

Interest accruing on impound accounts

When the property securing a loan is a one-to-four unit residential property and the loan has an impound account, the financial institution holding the loan must pay 2% annual simple interest on any balance in the impound account. A fee cannot be charged for maintaining the impound account if it would cause the interest received on the account to fall below 2%. [CC §2954.8(b)]

A financial institution includes a bank, savings and loan association (S&L), credit union, or any other person or organization making loans secured by one-to-four unit residential property. [CC §2954.8(c)]

However, **carryback sellers** are not financial institutions. Thus, they are not required to pay interest on impound accounts established in a carryback trust deed.

Also, the seller is not required to maintain a separate bank account for the impounds.

Unlike trust funds, a carryback seller or lender may commingle the owner's impounds with its general funds and retain all the benefits from these funds.

However, the impound funds must remain in the state of California. If invested, the funds can only be invested with residents of the state or partnerships and corporations which are engaged in business in the state. [CC §2955]

Calculating payments and reserves

One method used by lenders and carryback sellers for calculating an impound account balance is found in Real Estate Settlement Procedures Act (RESPA) regulations. [24 CFR §3500 Appendix E]

Consider the sale of any type of real estate in which the seller will carry back a note and trust deed. The carryback seller will also maintain an impound account.

Figure 11

Impound account deposit

(Determines largest shortfall for disbursements)

	pmt	disb	bal
June	0	0	0
July	$417	0	$417
August	$417	0	$833
September	$417	0	$1,250
October	$417	0	$1,667
November	$417	0	$2,083
December	$417	$4,300	-$1,800
January	$417	0	-$1,383
February	$417	0	-$967
March	$417	0	-$550
April	$417	0	-$133
May	$417	$700	-$417
June	$417	0	$0

Figure 12

Adjusted balances

(Lowest initial impound balance)

	pmt	disb	bal
June	0	0	$1,800
July	$417	0	$2,217
August	$417	0	$2,633
September	$417	0	$3,050
October	$417	0	$3,467
November	$417	0	$3,883
December	$417	$4,300	$0
January	$417	0	$417
February	$417	0	$833
March	$417	0	$1,250
April	$417	0	$1,667
May	$417	$700	$1,383
June	$417	0	$1,800

Figure 13

Initial deposit for impound account

(Advance deposit to build reserves)

	pmt	disb	bal
May (deposit)	$2,633	0	$2,633
June	0	0	$2,633
July	$417	0	$3,050
August	$417	0	$3,466
September	$417	0	$3,883
October	$417	0	$4,300
November	$417	0	$4,716
December	$417	$4,300	$833
January	$417	0	$1,250
February	$417	0	$1,666
March	$417	0	$2,083
April	$417	0	$2,500
May	$417	$700	$2,216
June	$417	0	$2,633

The buyer will incur:

- annual property taxes of $4,300, due on December 10; and
- an annual hazard insurance premium of $700, due on May 15.

Escrow will close on May 15 and the first payment is due to the carryback seller on the first of July.

The monthly impound balances are calculated to set the **initial deposit** necessary to avoid negative impound balances during any month.

The initial deposit for the impound account and the monthly impound payments are calculated based on whether:

- each disbursement by the seller from the impound account will be timely made; and
- the payments into the impound account by the buyer are one twelfth of the total annual property taxes and insurance premiums due. [See Figure 11]

From the balance in the impound calculated monthly in Figure 1, the lowest monthly balance — a deficiency — is to be **initially deposited** by the owner to keep the impound account balance from dropping below zero during any one month. [See Figure 12]

In our example, December has the lowest monthly balance of (-)$1,800. [See Figure 11]

Also, a permissible reserve balance equal to one sixth of the total annual disbursements is added to the impound account balances.

In our example, the reserve is $833 — one sixth of $5,000 in taxes and insurance premiums.

Thus, the initial deposit in the impound account is the $1,800 deficiency and the one sixth reserve, which equals $2,633. During the first year of loan payments, the buyer's monthly payment into the impound account is $417. [See Figure 11 and 13]

Chapter 10 — A modernized trust deed

This chapter introduces and explains a modernized trust deed used in California by carryback sellers and private lenders outside the national secondary mortgage market.

Reflecting enforcement limitations

Two basic forms of a trust deed exist, a long form and a short form.

The **long-form trust deed** contains on its face all the provisions the parties agree to for the encumbrance of the secured property. [See Form 450 accompanying this chapter]

When a long-form trust deed is used, the entire document must be recorded.

On the other hand, the short-form trust deed is usually one page long and contains only basic factual information — the parties, the property, the obligation secured and the borrower's signature.

The lengthy provisions contained on the face of a multi-page long- form trust deed are only referenced in the short-form trust deed, as appearing on a *fictitious deed of trust* previously filed with the county recorder. The provisions in the fictitious trust deed appear in condensed form on the reverse (unrecorded) side of the short-form trust deed.

The recorded **fictitious trust deed** referenced in the short- form is a blank, long-form trust deed.

Even though provisions in the fictitious trust deed are not printed in the body of the short form, the parties are nonetheless bound by them due to the reference.

Limited enforceability of provisions

Through the provisions of a trust deed, the private lender or carryback seller, also called a *secured creditor*, tries to restrict or regulate as many aspects of **ownership and possession** of the liened property as legally possible.

At first glance, the list of rights given to the private lender or carryback seller seems to authorize their use of tremendous **discretionary powers** over activity normally conducted by owners of real estate.

For example, trust deeds routinely purport to give the secured creditor the unhindered ability to:

- automatically accelerate the balance of the loan on the transfer of any interest in the property, such as a sale, further encumbrance or lease of the property;
- determine the allocation of condemnation (eminent domain) proceeds;
- apply all fire insurance proceeds to the secured debt; and
- call the loan if it or any other loan between the parties is in default, called a *dragnet clause*.

Fortunately for the owner and buyer, California law curbs the secured creditor's ability to strictly enforce **discretionary provisions**, as well as many other clauses which appear in some trust deeds.

First, trust deeds are recognized as *adhesion contracts*, offered by a person with superior bargaining power (the secured creditor) to a weaker person (the borrower) on a "take it or leave it" basis.

A prospective borrower typically has no power to negotiate better terms than those provided in regular trust deeds. The printed terms must be adhered to when borrowing money.

This imbalance in bargaining power led California courts to develop special adhesion contract rules for interpreting rights and obligations under trust deeds. [**Steven** v. **Fidelity and Casualty Company of New York** (1962) 58 C2d 862]

One adhesion theory rule requires a trust deed to be interpreted in light of the reasonable expectations of the weaker party, the borrower. [**Yeng Sue Chow** v. **Levi Strauss & Co.** (1975) 49 CA3d 315]

Second, as the discussion of each individual trust deed provision shows, many of the rights claimed by the secured creditor are restricted, if not completely unenforceable for lack of any basis for protecting the lender against loss of their loan.

The purported rights of the secured creditor, agreed to by the buyer or owner when executing the trust deed, are controlled by statutes, case law interpretations regarding fairness and good faith, and ancient common law doctrines governing the conduct of persons holding an interest in real estate.

As a result of California's specific *mortgage law*, the mere inclusion of an otherwise valid and enforceable general *contract clause* in a trust deed does not legitimize its use, or give the trust deed lender unlimited power to enforce it.

Provisions

The following sections analyze the necessary and enforceable provisions in a regular trust deed securing the performance of a note. Section references are to **first tuesday's** Form 450 — Long Form Deed of Trust and Assignment of Rents, accompanying this chapter.

2.1 — Condition of property

A **condition of property provision**, also called a **nonwaste provision**, obligates the owner to maintain the property in good physical condition. It covers two events.

First, the provision is, in its purpose for protection, a redundant recital. An owner of secured property is barred by statute from impairing the creditor's security interest in the property, called *waste*. [Calif. Civil Code §2929]

Secondly, inclusion of the nonwaste provision is necessary to give the secured creditor the **right to call** the secured loan on a breach of the owner's obligation to maintain the secured property in an unimpaired condition. If the loan is not paid in full on the call, the creditor may commence foreclosure. Without the provision, the creditor is limited to a court action for money damages, injunction and receivership of the property under the waste statute.

Conversely, a nonwaste provision in the trust deed is unenforceable if it is unrelated to protecting the value of the creditor's security from impairment. The owner of the secured real estate has the right to use the property as he wishes and is limited only by general land-use laws.

An owner's promise to maintain the property only bars him from activities and use of the property which jeopardizes the value of the creditor's security interest in the property. [**Krone** v. **Goff** (1975) 53 CA3d 191]

For example, many trust deeds contain a clause in which the owner promises "not to commit, suffer or

permit any act upon said property in violation of law". Such a **violation of law provision** is unenforceable, since it address activities unrelated to the maintenance or value of the secured property. Provisions promising to comply with laws **affecting** the property's value are enforceable, and are properly included in the nonwaste provision.

2.2 — Hazard insurance

Under the **hazard insurance provision**, the secured creditor has the right to **call the loan** when the owner fails to provide hazard insurance which is acceptable to the creditor.

Should the owner then fail to satisfy the loan after the call, the secured creditor can:

- begin foreclosure immediately, subject to the owner's right to reinstate by providing acceptable insurance; or
- acquire acceptable insurance, pay the premium and either add the amount to the debt under the future advances clause in the trust deed and continue to accept payments on the note, or make a demand for reimbursement, and if not paid in full, call the loan and commence foreclosure.

The secured creditor can require the owner to carry hazard insurance up to the **replacement cost** of any improvements, even if the costs exceed the loan amount or the property's fair market value. [CC §2955.5]

However, the secured creditor must allow the owner to rebuild damaged improvements, unless the rebuilding effort would impair the creditor's security. [**Schoolcraft** v. **Ross** (1978) 81 CA3d 75]

2.3 — Attorney fees

Attorney fees and costs incurred to protect the secured creditor's security interest in the property are recoverable under the **attorney fees provision** to the extent the fees are reasonable. [**Buck** v. **Barb** (1983) 147 CA3d 920]

Trust deeds give the secured creditor remedies to protect his security interest in the real estate. *Remedial actions* are unrelated to the collection of the debt evidenced by the note or other document and secured by the trust deed. Thus, an attorney fees provision is needed in the trust deed, even though the note contains an attorney fees provision. [**Hellier** v. **Russell** (1902) 136 C 143]

Attorney fees paid by the secured creditor for professional services needed to enforce the trust deed are considered future advances, and are thus secured by the trust deed.

If the secured creditor records a Notice of Default (NOD), all amounts advanced (including reasonable attorney fees incurred to enforce provisions on or protect the status of the trust deed) must be paid to reinstate the trust deed. [**Bisno** v. **Sax** (1959) 175 CA2d 714; CC §2924c]

Conversely, recovery of attorney fees or trustee's fees incurred to judicially or nonjudicially foreclose on the property under the trust deed lien are capped by statute.

2.4 — Taxes and senior encumbrances

The **tax and senior encumbrance provisions** obligate the owner to keep all taxes and senior liens current. If the owner fails to do so, the junior creditor may call the loan due and either:

- foreclose if not reimbursed; or
- pay the taxes under the future advances clause and add that amount to the loan balance. [CC §2876]

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

LONG FORM TRUST DEED AND ASSIGNMENT OF RENTS

Securing a Promissory Note

This Deed of Trust, made this ____________________ day of _______________________________, 20______, between ____, as the Trustor, whose address is ____,
(Number and street) (City) (State) (Zip)
____, a California corporation, as the Trustee, and ____, as the Beneficiary.

1. Trustor hereby **IRREVOCABLY GRANTS TO TRUSTEE IN TRUST, WITH POWER OF SALE,**

1.1 The real property in the City of ____,
County of ____, California, referred to as:

1.2 TOGETHER WITH the rents, issues and profits of the real property, subject to the provisions of §3.4, herein to collect and apply the rents, issues and profits,

1.3 **For the purpose of securing payment of:**

a. the indebtedness evidenced by a promissory note of same date executed by Trustor, in the sum of $_____________;

b. any additional sums and interest hereafter loaned by Beneficiary to the then record Owner of the real property, evidenced by a promissory note or notes, referencing this Deed of Trust as security for payment;

c. the Beneficiary's charge for a statement regarding the secured obligations requested by or for Trustor; and

d. the performance of each agreement contained in this Deed of Trust.

2. To protect the security of this Deed of Trust, Trustor agrees:

2.1 **CONDITION OF PROPERTY** — To keep the property in good condition and repair; not to remove or demolish any building; to complete and restore any building which may be constructed, damaged or destroyed; to comply with all laws affecting the property or requiring any alterations or improvements to be made; not to commit or permit waste; to cultivate, irrigate, fertilize, fumigate, prune and do all other acts which from the character or use of the property may be reasonably necessary.

2.2 **HAZARD INSURANCE** — Trustor will continuously maintain hazard insurance against loss by fire, hazards included within the term “extended coverage,” and any other hazards for which Beneficiary requires insurance. The insurance shall be maintained in the amounts and for the periods Beneficiary requires. The insurance carrier providing the insurance shall be chosen by Trustor, subject to Beneficiary’s approval, which shall not be unreasonably withheld. All insurance policies shall be acceptable to Beneficiary, and contain loss payable clauses in form acceptable to Beneficiary. Beneficiary shall have the right to hold policies and renewals.

In the event of loss, Trustor shall give prompt notice to the insurance carrier and Beneficiary. Beneficiary may make proof of loss if not made promptly by Trustor. Beneficiary may place the proceeds in a non-interest bearing account to be used for the cost of reconstruction of the damaged improvements. If Trustor fails to reconstruct, Beneficiary may receive and apply the loan proceeds to the principal debt hereby secured, without a showing of impairment.

2.3 **ATTORNEY FEES** — To appear in and defend any action or proceeding purporting to affect the security, or the rights and powers of Beneficiary or Trustee; and to pay all costs and expenses, including cost of evidencing title and attorney fees in a reasonable sum, in any such action or proceeding in which Beneficiary or Trustee may appear.

2.4 **TAXES AND SENIOR ENCUMBRANCES** — To pay at least 10 days before delinquency: all taxes and assessments affecting the property, including water stock assessments when due, all encumbrances, charges and liens, with interest, on the property which are or appear to be senior to this Deed of Trust; and all expenses of this Deed of Trust.

2.5 **ACTS AND ADVANCES TO PROTECT THE SECURITY** — If Trustor fails to make any payment or to perform any act provided for in this Deed of Trust, then Beneficiary or Trustee may, without obligation to do so, and with or without notice or demand upon Trustor, and without releasing Trustor from any obligation under this Deed of Trust:

a. make or do the same to the extent either deems necessary to protect the security, Beneficiary or Trustee being authorized to enter upon the property to do so;

b. appear in or commence any action or proceeding purporting to affect the security, or the rights or powers of Beneficiary or Trustee;

c. pay, purchase, contest or settle any encumbrance, charge or lien that appears to be senior to this Deed of Trust.

In exercising the power of this provision, Beneficiary or Trustee may incur necessary expenses, including reasonable attorney fees.

Trustor to immediately pay all sums expended by Beneficiary or Trustee provided for in this Deed of Trust, with interest from date of expenditure at the same rate as the principal debt hereby secured.

3. It is further mutually agreed that:

3.1 **ASSIGNMENT OF DAMAGES** — Any award of damages made in connection with:

a. condemnation for use of or injury to the property by the public, or conveyance in lieu of condemnation; or

b. injury to the property by any third party;

is assigned to Beneficiary, who may apply or release the proceeds of such award in the same manner and with the same effect as above provided for the disposition of hazard insurance proceeds.

3.2 **WAIVER** — By accepting payment of any sum due after its due date, Beneficiary does not waive Beneficiary’s right to either require prompt payment when due of all other sums or to declare a default for failure to pay. Beneficiary may waive a default of any agreement of this Deed of Trust, by consent or acquiescence, without waiving any prior or subsequent default.

3.3 **DUE-ON-SALE** — Should Trustor sell, transfer or convey any interest in the property, legal or equitable, either voluntarily or by operation of law, then Beneficiary may, at Beneficiary’s option, declare all sums secured by this Deed of Trust immediately due and payable.

3.4 **ASSIGNMENT OF RENTS** — Trustor hereby assigns and transfers to Beneficiary all right, title and interest in rents generated by the property, including rents now due, past due or to become due under any use of the property, to be applied to the obligations secured by this Deed of Trust.

a. Prior to a default on this Deed of Trust by Trustor, Trustor shall collect and retain the rents.

b. On default by Trustor, Beneficiary shall immediately be entitled to possession of all unpaid rents.

3.5 **ACCELERATION** — If payment of any indebtedness or performance of any agreement secured by this Deed of Trust is in default, Beneficiary may at Beneficiary's option, with or without notice to Trustor, declare all sums secured immediately due and payable by:

a. commencing suit for their recovery or for foreclosure of this Deed of Trust; or

b. delivering to Trustee a written notice declaring a default with demand for sale; a written Notice of Default and election to sell to be recorded by Trustee.

3.6 **TRUSTEE'S SALE** — On default of any obligation secured by this Deed of Trust and acceleration of all sums due, Beneficiary may instruct Trustee to proceed with a sale of the secured property under the power of sale granted herein, noticed and held in accordance with Calif. Civil Code §2924 et seq.

3.7 **TRUSTOR'S OFFSET STATEMENT** — Within 10 days of Trustor's receipt of a written request by Beneficiary, Trustor shall execute a written estoppel affidavit identifying for the benefit of any assignee or successor in interest of Beneficiary: the then owner of the secured property; the terms of the secured note, including its remaining principal balance; any taxes or assessments due on the secured property; that the secured note is valid and the Trustor received full and valid consideration for it; and that Trustor understands the note and this Deed of Trust are being assigned.

4. ADDENDA — If any of the following addenda are executed by Trustor and recorded together with this Deed of Trust, the covenants and agreements of each shall incorporate, amend and supplement the agreements of this Deed of Trust (check applicable boxes):
☐ Owner-occupancy rider; ☐ All-inclusive trust deed addendum; ☐ ___________________________;
☐ Impounds for taxes and insurance addendum; ☐ Private Mortgage Insurance (PMI) rider.

5. RECONVEYANCE — Upon written request from Beneficiary stating that all sums secured by this Deed of Trust have been paid, surrender of this Deed of Trust and the note to Trustee for cancellation, and payment of Trustee's fees, Trustee shall reconvey the property held under this Deed of Trust.

6. SUCCESSORS, ASSIGNS AND PLEDGEES — This Deed of Trust applies to, inures to the benefit of, and binds all parties hereto, their heirs, legatees, devisees, administrators, executors, successors and assigns. The term Beneficiary shall mean the holder and owner of the secured note, or, if the note has been pledged, the pledgee.

7. TRUSTEE'S FORECLOSURE NOTICES — The undersigned Trustor requests a copy of any Notice of Default and of any Notice of Sale hereunder be mailed to Trustor at the address herein set forth.

☐ See attached Signature Page Addendum. [**ft** Form 251]

Date: ____________, 20_____ Trustor: ____

Date: ____________, 20_____ Trustor: ____

STATE OF CALIFORNIA
COUNTY OF____
On ____ before me,
____
(Name and title of officer)
personally appeared ____
____,

who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

Signature ____
(Signature of notary public)

(This area for official notarial seal)

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Should a senior lender commence foreclosure and the loan not be reinstated or paid in full, the senior lender's foreclosure sale will wipe out any junior creditor's security interest in the property as a lienholder.

Similarly, property tax liens annually attach to the property and are senior to all trust deed holders. A tax lien which is delinquent must be foreclosed after five years. Any property tax sale will eliminate a creditor's secured position in the title. [Calif. Revenue and Taxation Code §2192.1]

2.5 — Acts and advances to protect the security

The **future advances provision** obligates the owner to reimburse the secured creditor on demand for any amounts advanced by the creditor under any provision of the trust deed — e.g., to pay insurance premiums, defend the security, or bring taxes and senior liens current.

All advances made by the secured creditor become part of the debt secured by the trust deed. If the owner fails to reimburse the secured creditor, the creditor may call due (accelerate) all amounts secured by the trust deed and foreclose on the property if the call is not fully paid, unless the debt is brought current as permitted by reinstatement rules. [**Windt** v. **Covert** (1907) 152 C 350]

3.1 — Assignment of damages

Condemnation:

Government agencies sometimes condemn part or all of a secured property in an *eminent domain action*, or damage the value of the property by their actions. Here, the agency must compensate the secured creditor for the loss of his security, which occurs on the date of the **taking**, and for any loss of money suffered by the owner. [Calif. Code of Civil Procedure §1260.220]

Accordingly, any condemnation award made to the owner of the secured property is subject to the lien created by the trust deed. Equity law requires the money award to stand as *substitute security* for the property it replaces. [**American Savings and Loan Association** v. **Leeds** (1968) 68 C2d 611]

However, the assignment of condemnation proceeds to the secured creditor under the **condemnation provision** in the trust deed is not the absolute assignment it appears to be. The creditor is not allowed to first apply the entire amount of the condemnation proceeds to the satisfaction of the secured debt if any portion of the secured real estate remains after the taking.

Rather, the assignment provision is merely a *collateral assignment* of the funds for the purpose of securing the debt. Thus, the secured creditor may keep only that portion of the condemnation proceeds necessary to **prevent impairment** of his security, called exercising control in good faith. The remaining funds must be released to the owner. [**Milstein** v. **Security Pacific National Bank** (1972) 27 CA3d 482]

With a partial taking, the secured creditor shares the award only to the extent necessary to protect and maintain the level of his security interest. If the partial taking does not create an impairment (reduces the property's value), the creditor is not entitled to any of the proceeds. [CCP §1265.225]

Impairment may occur even though the value of the property after a partial taking exceeds the balance outstanding on the debt. When the debt-to-equity or *loan-to-value ratio* (LTV) existing before the taking is altered substantially due to a reduction in value by the partial taking, the secured creditor is entitled to a portion of the funds needed to bring his debt-to- equity ratio back in line with the pre-taking ratio.

Any dispute regarding the extent of the secured creditor's impairment will be resolved by comparing the debt- to-equity ratios before and after the taking. Other risk factors influencing the impairment include

the owner's payment history, the economic effect of the taking on the remainder of the property, and whether the creditor has recourse on the obligation. [**People** v. **Redwood Baseline Ltd.** (1978) 84 CA3d 662]

Injury to the property by third-parties:

Coupled with the trust deed provision which collaterally assigns condemnation proceeds to the secured creditor is a **third-party injury clause**. It provides for the creditor an assignment of the award received by the owner for injuries to the property inflicted by private third parties.

Thus, the secured creditor may recover awards received by the owner for damages to the property, subject to the same standards of good faith impairment which apply to the provisions assigning condemnation awards and insurance proceeds. [**Duarte** v. **Lake Gregory Land and Water Co.** (1974) 39 CA3d 101]

However, only judgments compensating the owner for **actual injury** to the physical property which reduces its value may be participated in by the secured creditor.

3.2 — Waiver

The **nonwaiver provision** establishes the secured creditor's right to accept partial payments of amounts due under the note and trust deed, without waiving the right to commence or continue foreclosure based on the owner's default in payments. [**M.E. Hersch** v. **Citizens Savings and Loan Association** (1983) 146 CA3d 1002]

The second part of the nonwaiver provision is a **general waiver** which allows the secured creditor to forego enforcement of the trust deed provisions on a default without waiving his right to commence foreclosure on a later default.

For example, the secured creditor's consent to a transfer of the real estate under the trust deed's due-on clause does not waive the right of the lender to interfere with further transfers, unless the creditor agrees in writing to waive his right to call or recast the debt on future transfers.

3.3 — Due-on-sale

A secured creditor may enforce his **due-on clause**, also called an *alienation clause*, by automatically calling the debt due on a voluntary or involuntary transfer of any legal or equitable interest in the property. [12 Code of Federal Regulations §591.2]

3.4 — Assignment of rents

Two types of **assignment of rents provisions** exist:

- an absolute assignment; and
- a conditional assignment.

However, the distinction between the two types of assignment of rents clauses is not of concern to the holder of a trust deed recorded after 1996.

Editor's note — For assignment of rents clauses recorded before 1997, the rules regarding the distinctions between the two types of rent clauses still govern their perfection and enforcement.

A trust deed executed and delivered after 1996, containing either type of assignment of rents clause, creates a *present security interest* in existing and future leases, rents, issues or profits on the secured real estate. This security interest is referred to as a *lien*. [CC §2938(a)]

The assignment of rents clause may be in a separate lien agreement, but is usually placed in the trust deed recorded against the real estate involved.

Once the assignment is recorded, it:

- gives *constructive notice* to all persons of the lender's security interest in the rents; and
- is *fully perfected* even though the provision states the assignment is unenforceable until a default occurs on the note or trust deed. [CC §2938(b)]

Perfection by recording establishes the lender's security interest in the rents has priority over security interests in the rents later acquired by other creditors or owners of the property.

3.5 — Acceleration

The trust deed debt **acceleration provision** allows the secured creditor to call the full amount of all sums secured by the trust deed due and payable on **any default** under the provisions of the trust deed by the owner.

Although not necessary, notes secured by trust deeds also contain acceleration clauses. However, trust deed provisions relate to the property and are not properly contained or referenced in the note secured by the trust deed.

Thus, an acceleration provision in the trust deed allows the secured creditor to accelerate payment of all secured obligations (not just the debt evidenced by the note) when the owner breaches any provision of the trust deed, which includes a default on the note.

Also, the acceleration provision in the trust deed gives notice to future owners and encumbrancers of the property that the secured obligation can be accelerated on any default. [CC §1214]

Of course, any acceleration is subject to reinstatement rights, except for calls under the due-on clause and violations of law affecting the real estate since they are incurable breaches requiring redemption of the property by payment in full.

3.6 — Trustee's sale

The **power of sale provision** grants to an unnamed trustee, coupled with an agreement between the owner and the secured creditor to hold a sale of the property on the owner's default, the authority to sell the property by a private trustees' sale if the owner defaults. [CC §2924 et seq.]

The completion of a trustee's foreclosure sale extinguishes the owner's ownership interest in the property and terminates his right to redeem the property by paying off the debt. [CC §2903]

3.7 — Trustor's offset statement

If the secured creditor later sells or collaterally assigns the trust deed note to a trust deed investor, the **offset statement provision** requires the owner to cooperate by completing and delivering a trustor's offset statement for use by the trust deed investor. [See **first tuesday** Form 428]

The trust deed investor buying or lending on the note will require the statement to confirm whether the note is valid.

The statement is requested by the secured creditor through the trust deed sales escrow, and delivered to the trust deed investor.

The trustor's offset statement confirms the terms of the note and the existence of any claims or offsets held by the owner against the note or the trust deed holder assigning the note. The offset information is necessary to establish the assignee's status as a holder in due course on his acquisition of a trust deed note.

The owner of the secured real estate has no duty to respond to the request for an offset statement, unless agreed to in the note or trust deed.

4 — Addenda

Special use agreements not covered by standard boilerplate provisions in the trust deed are attached as addenda to the trust deed, sometimes called *riders*.

Examples include:

- the all-inclusive trust deed (AITD) addendum [See **first tuesday** Forms 442 and 443];
- agreements for impound accounts;
- owner-occupancy riders; and
- agreements for mortgage indemnity insurance.

5 — Reconveyance

Within 30 days after payoff of the secured obligation, the secured creditor must deliver instructions to the trustee to record a **deed of reconveyance** or reconvey the trust deed himself. Both the note and the trust deed are returned to the property owner when the debt is fully satisfied. [CC §2941]

Failure by the secured creditor or trustee to reconvey is a misdemeanor, punishable by a fine of up to $400 and up to six months in jail, or both. Also, the secured creditor or trustee who fails to reconvey is liable for any losses sustained by the owner as a result, plus a civil penalty of $300. [CC §§2941.5, 2941(d)]

6 — Successors, assigns and pledgees

A **successor and assignee provision** extends the rights and obligations under the trust deed to all successors-in- interest of the owner of the secured real estate and the secured creditor.

Even without a successor provision, the owner's successor takes title to the secured property subject to the secured creditor's trust deed, regardless of whether he has in any manner assumed the owner's obligations on the secured note. Thus, the successor must maintain the terms of the note, even though he is not a party to it, to prevent losing the property to foreclosure, called *privity of estate*. [**Rodgers** v. **Peckham** (1898) 120 C 238]

Further, the owner can enforce provisions in the trust deed against the creditor even though he did not assume the obligations of the note and trust deed since a subject-to buyer's ownership of the property is the interest which secures the creditor's recovery on the note. [**Saucedo** v. **Mercury Savings and Loan Association** (1980) 111 CA3d 309]

7 — Trustee's foreclosure notices

A county recorder can only record those trust deeds which contain an owner's request for a notice of default (NOD). [Calif. Government Code §27321.5]

The trustee commencing foreclosure proceedings must mail a copy of the NOD by certified or registered mail, and a second copy by first-class mail, to the owner's last known address. [CC §2924b(b)]

If the owner fails to specify his address in the trust deed or changes his address, he may later request the NOD be mailed to him at a new address by recording a statutory **Request for NOD** form. [CC §2924b(a); see **first tuesday** Form 412]

If there is no address for the owner in the trust deed or Request for NOD form, the trustee must:

- **publish** a copy of the NOD in a newspaper of general circulation in the county where the property is located, once a week for four consecutive weeks commencing within ten days of recording the NOD;
- personally **deliver** a copy of the NOD to the borrower within ten days of recording or before publication is completed; or
- **post** a copy of the NOD in a conspicuous location on the property and mail a copy of the notice to the buyer's last known address. [CC §2924b(d)]

Junior secured creditors also request NODs and Notices of Delinquency (NODq) to better protect their interests in the secured property against foreclosure and extended delinquencies allowed by a senior lender. [See Chapter 7]

Chapter 11 Due-on-sale regulations

This article clarifies the events which trigger a lender's due-on clause, and analyzes the adverse economic effects of due-on regulations on the real estate market.

Rising rates bring lender interference

During the good times of upward sales volume, expanding mortgage originations and increasing absorption rates for available rented space, the marketplace operates at full throttle.

Every sales activity feeds on every other sales activity. In their haste, few participants seem to care about the errors and inherent inefficiencies which get buried in the process.

Responsibility for all this frenzy lies primarily with the **gatekeepers** who control entry into real estate ownership and relocation – the brokers and lenders. All other parties to a real estate transaction are merely affiliated, providing closing services after the brokers linkup a buyer and a seller, and the lender qualifies the buyer and property for a purchase-assist loan. Singularly, the sale and the loan by these two guardians of real estate are the nucleus of a transaction. All that follows are support services.

During this virtuous cycle of rising prosperity for all, buyers tend to put up with the onerous threshold of entry procedures maintained by brokers and lenders. In the rush to do deals, all the numerous steps imposed to achieve ownership seem to be justified, or are simply overlooked as necessary tedium to get in on the act.

However, when short-term interest rates rise to outrun inflation, as they always must, they cause a recession and dampen buyer enthusiasm. The onerous restrictions on entry imposed by brokers and lenders during the good times are actually augmented and tightened to discourage the able and ready buyer by forcing them to become unwilling to put up with both the hassles of acquisition and a regime of higher rates and credit standards.

One restraint placed on the seller's marketability of title which interferes with the ability of a buyer and seller to make a deal is the due-on clause buried within the copy of all trust deeds. During boom years, buyers easily qualify for a new loan and sellers overlook prepayment penalties on a payoff. Distracted by the fast moving market, the due-on clause is at that moment a non-issue.

However, as the boom turns to bust for sellers, buyers and their brokers often see a financial benefit in taking over the seller's existing loan. The lender reaction to a bust becomes totally defensive, saying "no" to any type of loan takeover or assumption – *I want my prepayment penalty and I can re-lend the money at higher current rates*.

Thus, a claim that was not of concern and is based on a provision that did not inhibit deal making during boom times now places a noose about the seller's neck which is tightened by dropping property value. The combination of the due-on clause, rising rates and lost value ties the seller to his property without a way out from under the loan – short of foreclosure.

Attempts to circumvent the restraint

A parcel of real estate listed for sale is encumbered by a first trust deed loan containing a *due-on clause*. The listing agent locates a buyer for the property.

The purchase agreement negotiated between the buyer and the seller conditions closing on the buyer entering into a loan **assumption agreement** with the existing first trust deed lender. As additional financing, the seller will carry back a note secured by a second trust deed for the balance of the purchase price remaining after deducting the buyer's down payment and the amount assumed on the first trust deed loan.

The buyer is advised the lender may:

- refuse to allow the loan to be assumed with the implicit threat that the loan will be called on a transfer, forcing the buyer to obtain new financing if he is to amicably acquire the property; or
- require a *modification* of the loan at a less favorable rate than the note rate on the loan and demand an assumption fee.

Before opening escrow and contacting the lender to process an assumption, the buyer suggests restructuring the sale. He would convert it from a grant deed conveyance to a lease-option arrangement in an attempt to avoid due-on enforcement by the lender.

The buyer and seller discuss entering into a two-year lease agreement with the right to extend the lease for two years at an increased monthly payment. The buyer will be granted an option to purchase for the life of the lease.

The down payment will be restated as *option money*. The option money will apply to the purchase price of the property, as will a portion of each monthly payment, called *rent*.

Meanwhile, the seller will continue making payments on the trust deed loan. When the buyer exercises his purchase option, the loan will be assumed or paid off and the buyer will become the record owner of the property.

Does the lease-option sale avoid due-on enforcement by the lender?

No! Any lease agreement which contains an option to purchase triggers due-on enforcement by the lender on discovery. [12 Code of Federal Regulations §591.2(b)]

Lender interference under federal mortgage law

Generally, all lenders and carryback sellers are allowed to enforce their due-on sale clauses in trust deeds on nearly all transfers of an interest in any type of real estate. [12 United States Code §1701j-3, Garn-St. Germain Depository Institutions Act of 1982 (Garn)]

Thus, the *Garn Act* deprives Californians (and residents of numerous other states) of the use of their state law right to convey real estate subject to trust deed liens without lender interference with the transfer of ownership, unless the lender can show the buyer lacks creditworthiness, a federal legislative process called *pre-emption*.

The occurrence of an event which triggers due-on enforcement automatically allows the lender to:

- **call the loan**, demanding the full amount remaining due be paid immediately, also known as *acceleration*; or
- **recast the loan**, requiring a modification of the loan's terms as a condition for the lender's consent to a transfer, called a *waiver* of the lender's right to call.

The *Garn Act* encourages lenders to allow buyers to assume real estate loans at existing rates, but provides lenders no incentives to do so. The congressional intent in passing the *Garn Act* was to **pre-empt state law barriers** to due-on enforcement and allow lenders to increase their profits at the expense of property owners. However, the enforcement of the due-on clause by lenders was not intended to occur at the expense of permitting **excessive lender interference** with real estate transactions, be they sales, leases or further encumbrances. [12 USC §1701j-3(b)(3)]

Yet, when the Federal Home Loan Bank Board (now the Office of Thrift Supervision (OTS)) issued **due-on regulations** to implement *Garn*, no notice was taken of the congressional request for leniency when exercising due-on rights.

The OTS regulations allow automatic due-on enforcement on any transfer of an interest in real estate, with only a few family-related, single family residence exceptions. No encouragement or guidelines were established for lenders to consent to loan assumptions or to limit interference in commonplace transactions.

Since lenders often disregard the law in their trust deed lending and enforcement practices, it is hard to imagine why they would comply with a mere congressional request. In the absence of any regulatory obligation, and the courts having been removed from the equation, lenders use their due-on clauses to maximize their financial advantage over owners by calling or recasting loans on the sale of the secured property.

Thus, lenders increase their portfolio yield in a rising interest rate market when the secured property is sold, further encumbered or leased by using the due-on clause as a masked ARM provision to adjust the rate of interest on their loan.

Agents should not "assume" that just because a trust deed includes a due-on clause that the lender will not consent and that the loan is not assumable. Always ask for the lender's consent when it makes financial sense for the buyer to take over an existing loan; it won't hurt and it might help.

Economic recessions and recoveries

In times of stable or falling interest rates, lenders, when requested, usually permit assumptions of loans at the existing note rate, unless a prepayment penalty clause exists. Lenders have no financial incentive to recast loans, or call and re-lend the funds at a lower rate when interest rates are dropping in the marketplace.

However, in times of steadily rising rates, lenders seize any event triggering the due-on clause as an opportunity to increase the interest yield on their portfolio. Once the due-on clause is triggered, the lender requires the loan be recast at current market rates as a condition for allowing an assumption, further encumbrance or lease of the property by the owner.

Thus, owners of real estate encumbered by due-on trust deeds will experience greater difficulties when attempting to sell and transfer ownership in an environment of rising interest rates. Too frequently owners are "imprisoned" in their own home as a result. Lender due-on interference is virtually guaranteed during periods of rising interest rates since the interference results in an increase in the lender's portfolio yield which permits them to remain solvent, if not the owner.

Thus, an adverse *inhibiting effect* on buyers takes place during recessions when interest rates charged on new loans are higher than the rate on the seller's loan. Buyers resist being required to assume existing financing at higher interest rates. Not only is there an adverse economic effect on real estate sales, the

availability of private junior financing and long-term leasing is seriously compromised by the existence of the due-on clause. Ultimately, as rates and lender interference rise, many buyers, equity lenders and long-term tenants (more than a three-year term) are driven out of the market, which further depresses property values.

Meanwhile, owners are faced with the prospect of watching the value of their property fall below their remaining loan balance, leaving no equity in the property. It is a vicious cycle which evolves into a dramatic increase in loan foreclosures, the antithesis of the profit motive driving lender enforcement of the due-on clause.

Due-on interference was an obscure issue during the 12-year period (1982 through 1994) after *Garn* became law. During this period, mortgage rates declined from 15% to 7% (except for a short period following late 1998), the earnings of buyers increased as inflation dropped and mortgage money became more plentiful due to reduced government borrowing. All that has been reversed since 1999.

Due-on-sale

Due-on clauses are most commonly known as *due-on- sale* clauses. However, "due-on clause" is a more accurate term since a sale is not the only event triggering the clause. Still, as the name "due-on-sale" suggests, the primary event triggering the lender's due-on clause is a sale of property which is subject to the lender's trust deed lien.

The due-on clause is triggered not only by a transfer using and recording a standard grant deed or quitclaim deed, but by any conveyance of legal or equitable ownership of real estate, whether or not it is recorded. Examples include a land sales contract, lease-option sale, or other alternative carryback devices, such as an all-inclusive trust deed (AITD).

For example, a land sales contract does not involve an immediate conveyance of real estate to the buyer by grant deed. The seller on a contract (for deed) retains title as security for the carryback debt owed by the buyer rather than using a trust deed lien to evidence his security interest. However, the buyer becomes the *equitable owner* of the property as soon as the land sales contract is entered into and possession is transferred, triggering the due-on clause in any existing trust deed. [**Tucker** v. **Lassen Savings and Loan Association** (1974) 12 C3d 629]

Whether the seller carries back a regular second trust deed or an AITD, you always need the consent of the senior lender when a due-on clause exists in their trust deed.

Due-on-lease

The due-on clause is also triggered by:

- a lease with a term over three years; or
- a lease for any term complied with an option to purchase granted to the tenant. [12 CFR §591.2(b)]

For example, an owner with a short-term interim construction loan for nonresidential rental property obtains a conditional commitment from a long-term lender for take-out financing to pay off the construction loan. Funding of the take-out loan is conditioned on the property being 80% occupied by tenants with an initial lease term of at least five years.

The owner locates tenants for 80% of the newly constructed property, all with a lease term of five years

“It has recently come to our attention . . .”

Trust deed called or recast at lender’s option

Events triggering the due-on clause

Sale:

- transfer of legal title (grant or quitclaim deed);
- land sales contract or holding escrow;
- court-ordered conveyance; or
- death.

Lease:

- lease for more than three years; or
- lease with an option to buy.

Further encumbrance:

- creation or refinance of a junior lien; or
- foreclosure by junior lienholder.

Transfers not triggering due-on enforcement

(owner-occupied, four-or-less residential)

- creation of junior lien where owner continues to occupy;
- transfer to spouse or child who occupies;
- transfer into inter vivos trust (owner obtains lender’s consent and continues to occupy);
- death of a joint tenant; or
- transfer on death to a relative who occupies.

or more. The lender funds the loan. The loan is secured by a first trust deed on the property which contains a due-on clause. The existing five-year leases do not trigger the due-on clause in the lender's trust deed. The long-term leases have priority since they were entered into before the loan funded and the trust deed recorded.

However, after obtaining the loan, the owner continues to lease out space in his property for five year terms. Later, after interest rates rise, a representative of the lender (a prior loan officer) visits the property and "discovers" new tenants. On inquiry, the officer learns that some of the tenants entered into leases, or had their leases extended for periods greater than three years, after the loan was recorded.

The lender sends the owner a letter informing him it is calling the loan due since the owner has entered into lease agreements with terms over three years.

The owner claims the lender cannot call the loan since long-term leases were required by the lender as a condition for funding the loan.

Can the lender call the loan due or demand a recast of its terms?

Yes! By requiring leases with terms over three years as a condition for funding the loan, the lender did not waive its right to call or recast the loan under its due-on clause should a lease with a term over three years be entered into after the loan was originated.

However, an **assignment** or **modification** of an existing lease does not trigger the due-on clause, unless the lease is modified to extend the term beyond three years, or a purchase option is granted to the tenant.

For example, consider an owner of real estate who enters into a lease with an initial term of 10 years. Later, the owner takes out a loan secured by a trust deed containing a due-on clause. After the trust deed is recorded, the tenant assigns the lease with the owner's approval, as provided in the lease agreement (which has priority to the lender's trust deed).

However, the lender's due-on clause is not triggered by the lease assignment. The trust deed is attached as a lien only on the owner's fee interest, not the leasehold interest previously conveyed to the tenant. The fee owner whose interest is encumbered by the loan transferred nothing. The assignment of a leasehold by a tenant is not a transfer of any interest in the fee encumbered by the trust deed.

However, consider a landlord who releases the original tenant from all liability under the lease as part of an assumption of the lease by the new tenant and substitution of liability. The release of the original tenant from liability creates a *novation* of the lease — a new agreement conveying an interest in the secured property to the new tenant by the owner of the fee. [**Wells Fargo Bank, N.A.** v. **Bank of America NT & SA** (1995) 32 CA4th 424]

Thus, an assumption of the lease by a new tenant, and a release of the former tenant from liability, constitutes a present transfer of an interest affecting the fee ownership of the real estate since it is a novation. Accordingly, a lease **novation** triggers the due-on clause — if the lease has a remaining term of over three years or includes an option to purchase.

Due-on-further encumbrance

An owner-occupant of a single family residence (SFR) subject to a first trust deed applies for an **equity loan** to be secured by a second trust deed on his property. The first trust deed contains a due-on clause.

The loan broker tells the owner he is concerned about due-on enforcement by the senior lender, since the

execution of a second trust deed will convey a security interest in the property by encumbering it with a lien. On inquiry, the owner informs the broker he will continue to occupy the property as his residence.

The broker correctly assures the owner the second trust deed encumbrance will not trigger the senior lender's due-on clause, as long as the owner continues to occupy the residence. Due-on enforcement based on a further encumbrance of an owner- occupied, one-to-four unit residential property is not permitted. [12 CFR §591.5(b)(1)(i)]

However, on real estate other than an owner- occupied, one-to-four unit residential property, any further encumbrance without first obtaining the existing lender's waiver of its due-on clause triggers the due-on clause, giving the lender the right to call or recast the loan.

Thus, junior financing without a waiver of the senior lender's due-on clause becomes a risky enterprise for trust deed investors in times of rising interest rates. Increasing market rates give trust deed lenders a powerful incentive to call loans on the transfer of any interest in the secured real estate — with the exception of owner-occupied, one-to-four unit residential properties.

For example, a private lender accepting a junior trust deed position on a type of property other than an owner-occupied, one-to-four unit residence without first obtaining a **due-on waiver** from the senior lender risks having the economic value of his position in title:

- **reduced** by an increase in the interest rate on the first; or
- **wiped out** by the first's foreclosure, should the first exercise its due-on rights based on the further encumbrance and not be paid in full. [**La Sala** v. **American Savings & Loan Association.** (1971) 5 C3d 864]

Owners are forced to look elsewhere for funds when the existing lender does not grant a due-on waiver. Thus an owner is forced to refinance existing encumbrances in order to generate cash from their equity in the property, typically a more expensive process due to prepayment penalties and increased rates than had they obtained an equity loan.

Now consider a seller who carries back a second trust deed on the sale of property without the consent of the holder of the first trust deed which contains a due-on clause.

The first trust deed lender learns of the sale and calls the loan. To avoid the call, the buyer assumes the first trust deed loan and modifies the note by shortening the due date.

The carryback seller claims his second trust deed now has priority over the first trust deed since the modification of the first trust deed note substantially impairs his security by increasing the potential for default on his trust deed.

Here, the modification of the first trust deed note without the consent of the junior carryback seller does not result in a change in trust deed priorities since the existence of the second trust deed note is in violation of the due-on clause in the first trust deed.

When the secured property is sold and the seller accepts a second trust deed without receiving the lender's prior written consent, the due-on clause has been breached under federal mortgage law. Thus, no duty is imposed on the first trust deed lender to avoid further subordinating the interest of the holder of the unconsented-to junior lien by recasting the first trust deed note. [**Friery** v. **Sutter Buttes Savings Bank** (1998) 61 CA4th 869]

Due-on enforcement and prepayment penalties

Consider an owner of real estate which is encumbered by a trust deed securing a note containing a **prepayment penalty clause**. The owner sells the property, triggering the due-on clause in the lender's trust deed.

The lender, unwilling to consent to an assumption by the buyer, calls the loan due. The buyer obtains a new purchase-assist loan from a different lender, enabling the buyer to pay off the existing loan.

The lender informs the buyer he will have to pay a prepayment penalty due to his early payoff of the loan.

The buyer claims he cannot be charged a prepayment penalty since the early payoff was not the buyer's choice, but was a result of the lender exercising his right to call the loan due-on-sale. Thus, the note is due by its terms.

Can a lender charge a prepayment penalty after calling a loan due?

Yes! The prepayment penalty clause in most trust deeds allows the lender to charge a penalty if the loan is **voluntarily or involuntarily** paid off before the due date**.**

Before 1983, a lender's prepayment penalty clause frequently called for a penalty only if the property owner voluntarily paid off the loan before the due date. Thus, the lender was barred from enforcing prepayment penalties in an *involuntary payoff*, after calling a loan due under the due-on clause. [**Tan** v. **California Federal Savings and Loan Association** (1983) 140 CA3d 800]

The lenders' response to the *Tan* decision was to reword their prepayment penalty clauses to impose a penalty for any prepayment of the loan, whether voluntary or involuntary.

However, when a loan is secured by a trust deed on owner-occupied, one-to-four unit residential property, federal regulations bar the lender from imposing a prepayment penalty when accelerating the loan under its due-on clause. [12 CFR §591.5(b)(2)]

Due-on-foreclosure

A parcel of real estate is subject to first and second trust deed liens. An owner defaults on the first trust deed. The junior trust deed holder reinstates the first trust deed and forecloses on the second, acquiring the property at the trustee's sale.

The senior lender informs the junior lender, who now owns the property, that it is calling its loan due, based on the transfer of the property by trustee's deed.

Can the senior lender call its loan due based on the completion of foreclosure by the second trust deed lender?

Yes! A senior lender may call a loan due on completion of the **foreclosure sale** by a junior lender or carryback seller on any type of real estate. A *trustee's deed* on foreclosure is considered a voluntary transfer by the owner, since the power of sale authority in the junior trust deed was agreed to by the owner of the real estate.

However, the due-on clause is not only triggered by the voluntarily agreed-to trustee's sale, but also by any involuntary foreclosure, such as a tax lien sale. [**Garber** v. **Fullerton Savings and Loan Association** (1981) 122 CA3d 423]

Federal regulations allow due-on enforcement on **any transfer** of real estate which secures the lien, whether the transfer be voluntary or involuntary. [12 CFR §591.2(b)]

The risk of a senior lender enforcing its due-on clause on a trustee's sale by the junior lender has an **inhibitory effect** on the availability of junior trust deed loans and carryback sales. Many lenders and sellers are unwilling to accept a junior position which exposes them to paying off a senior debt should they be forced to foreclose on the real estate. [**Pas** v. **Hill** (1978) 87 CA3d 521]

Due-on-death and exceptions

Transfers of real estate which trigger due-on enforcement include the inevitable transfer resulting from the death of a vested owner even if title was vested in a revocable inter vivos trust. However, as with due-on enforcement triggered by further encumbrances, some exceptions on death apply to owner- occupied, one-to-four unit residential property.

For example, the transfer of a one-to-four unit residential property to a relative on the death of the owner-occupant does not trigger the due-on clause, on the condition the relative becomes an occupant of the property. [12 CFR §591.5(b)(1)(v)(A)]

Also, where two or more people hold title to one-to- four unit residential property as joint tenants, the death of one **joint tenant** does not trigger due-on enforcement as long as at least one of the joint tenants, whether it was the deceased or a surviving joint tenant, occupied the property at the time the loan was originated. Occupancy is not required for a surviving joint tenant who qualifies for the joint tenancy exception. [12 CFR §591.5(b)(1)(iii)]

In all other transfers, the death of a vested owner, joint tenant or other co-owner will trigger the lender's due-on clause. Thus, due-on enforcement is **triggered on death** by:

- a transfer of the deceased's residence to a non-relative, by will or by trust, following the death of the owner;
- the death of a joint tenant owning a one-to-four unit residential property which was not originally occupied by any of the surviving joint tenants;
- the death of a co-owner of any type of property other than one-to-four residential units; and
- the transfer of any property, other than the deceased's residence, to a relative or anyone else on the death of the owner.

Divorce and inter-family transfers

A married couple occupies a residence which is vested in the name of the husband and owned as his separate property. The residence is subject to a trust deed containing a due-on clause.

The couple separates and the residence is transferred to the wife as part of the **property settlement** to dissolve the marriage. The wife continues to occupy the residence.

Does the transfer of the residence to the wife on divorce trigger due-on enforcement by the lender?

No! Federal due-on regulations bar due-on enforcement on transfer of one-to-four unit residential property to a spouse after a divorce, so long as the spouse occupies the property. [12 CFR §591.5(b)(1)(v)(C)]

However, if the acquiring spouse chooses to lease the residential property to tenants for any length of time rather than occupy it, the lender can call or recast its loan.

Also, the due-on clause is not triggered by an owner's transfer of his one-to-four unit residential property to a **spouse or child** who occupies the property. [12 CFR §591.5(b)(1)(v)(B)]

This inter-family transfer exception for four-or-less residential property applies only to transfers from an owner to a spouse or child. For instance, any transfer from a child to a parent to provide housing for the parent triggers due-on enforcement.

Finally, consider an owner-occupant of one-to-four unit residential property who transfers the property into an *inter vivos trust*, naming himself as beneficiary. The owner continues to occupy the property after transferring title into the trust, commonly known as a *living trust*.

The owner **notifies the lender** he will be transferring title into the trust vesting. The owner agrees to give the lender notice of any later transfer of his beneficial interest in the trust or change in occupancy of the property as requested by the lender.

Would this transfer into a living trust trigger the due-on clause in a trust deed encumbering the owner's residence?

No! The owner met the federal regulatory conditions for avoiding due-on enforcement based on a transfer of owner-occupied, one-to-four unit residential property into an inter vivos trust. [12 CFR §591.5(b)(1)(vi)]

To meet regulations, the owner must provide means **acceptable to the lender** by which the lender will be given notice of any later transfer of the beneficial interest in the trust or change in occupancy. If the owner conveys the property into the inter vivos trust without the lender's approval of the notice provision, the lender may call the loan due.

The notification provision requires the owner to first obtain the lender's consent before transferring the property into a trust vesting.

Also, if the owner does not continue to occupy the property, or later transfers the beneficial interest in the trust, the lender can call or recast the loan.

Waiver by negotiation and by conduct

Under federal regulations, lenders have the power to dictate the fate of financing in most real estate transactions, since most real estate is encumbered by adhesion trust deeds containing due- on clauses.

However, an owner wishing to enter into a transaction to sell, lease or further encumber his real estate without lender interference must first negotiate a **limitation or waiver** of the lender's due-on rights.

Waiver agreements are basically trade-offs. The lender will demand some consideration in return for

waiving or agreeing to limit the exercise of its due-on rights in the future, such as increased points on origination, additional security, principal reduction, increased interest and larger payments, a shorter due date or an assumption fee.

For example, a buyer applies for a loan to purchase a residence which he intends to occupy for only a few years. The buyer is concerned due-on enforcement will later make it more difficult for him to resell the property since it will limit the seller's ability to finance the sale of his equity.

Thus, the buyer and the lender negotiate the conditions on which a later qualified buyer will be able to assume the loan without a call by the lender. In exchange for the lender's limitation of its future due-on rights, the buyer agrees to pay increased points or interest.

Any time a lender recasts a loan as a condition for consenting to a buyer's assumption, it is essentially forcing a *modification agreement* on the buyer. In exchange for agreeing not to call the loan due on a transfer of the property to the buyer, the lender receives consideration, such as increased interest and payments (the modification of the loan) and an assumption fee.

The lender's waiver of its due-on rights under an assumption agreement applies only to the present transfer to the buyer. Unless additionally agreed to, any **later transfer** of an interest in the property will trigger the due-on clause, allowing the lender to call or recast the loan again.

In addition to a waiver (assumption) agreement, waiver of the lender's due-on rights may occur **by conduct** — the lender loses its due-on rights by failing to promptly enforce them.

For example, a buyer purchases real estate subject to a loan secured by a trust deed containing a due-on clause. The lender is informed of the transfer and immediately calls the loan. However, the lender then accepts payments from the buyer for over a year. Finally, the lender seeks to enforce its prior call by refusing further payments and foreclosing.

However, the lender, **by its conduct**, waived the right to enforce its due-on clause. The lender accepted payments from the buyer for over a year after calling the loan on learning of the transfer of the real estate. [**Rubin** v. **Los Angeles Federal Savings and Loan Association** (1984) 159 CA3d 292]

Broker liability for due-on avoidance

When the seller intends to transfer ownership of the property to the buyer, the senior lender's due-on clause is triggered regardless of the form used to document the sales transaction.

Of course, the lender can only call the loan when it actually discovers a change of ownership has taken place. If the buyer's option is not recorded, and the lease agreement is for a term under three years, the lender might not discover any transfer of an interest in the real estate has taken place, which triggered its due-on clause.

If the lender later discovers a change of ownership has taken place, its only remedy against the buyer and seller is to call the loan due, or recast the loan as a condition for waiving its right to call and allowing an assumption by the buyer. Under the note and trust deed, the lender cannot recover the *retroactive interest differential* (RID) for the period before it discovered the transfer and called the loan. The only recourse against the buyer or seller is to call the loan and be paid in full or foreclose. [**Hummell** v. **Republic Federal Savings & Loan** (1982) 133 CA3d 49]

However, **an adviser**, such as a broker or attorney, assisting the buyer or seller to mask the change of ownership from the lender with the primary purpose of avoiding the lender's due-on enforcement, can be

held liable for wrongfully interfering with the lender's right to call or recast the loan, an offense called *tortuous interference with prospective economic advantage*.

The adviser's liability arises based on the extent to which his actions were **specifically intended** to conceal the transfer and prevent a call by the lender, and on the **foreseeability** the lender would incur losses due to the concealment. [**J'Aire Corporation** v. **Gregory** (1979) 24 C3d 799]

The lender's losses caused by the adviser's wrongful interference are calculated based on the *interest differential* between the note rate and the market rate on the date of sale, retroactively applied from the date of discovery by the lender to the date of the transfer.

Chapter 12 — Due-on waiver and junior financing

This chapter comments on the need for carryback sellers to negotiate a waiver of the senior lender's due-on clause on a sale subject to the lender's trust deed loan.

Prior planning prevents a call

A seller of real estate encumbered with a first trust deed lists the property for sale with his broker. The trust deed contains a due-on clause.

Later, the broker presents the seller with a purchase offer from a buyer on terms which include:

- a cash down payment;
- an assumption of the existing first trust deed by the buyer; and
- a carryback note executed by the buyer in favor of the seller for the balance of the purchase price, which will be secured by a second trust deed on the property.

The seller accepts the offer, and a sales escrow is opened. As part of their instructions, escrow requests a **loan assumption package** from the lender who holds the note secured by the existing trust deed.

Before the close of escrow, the lender approves the sale on one condition; the buyer **assumes** the loan obligation and agrees to a **modification** of the interest rate and payment schedule in the note. The buyer agrees to the lender's demands and signs the loan assumption and note modification agreement. The lender does not enter into a written consent agreement with the seller regarding the carryback second trust deed. However, the lender did receive a copy of the escrow instructions during the loan assumption process which discloses the carryback second trust deed as part of the sales transaction.

In this example, by consenting to the conveyance of the secured property to the buyer on the terms of the escrow instructions, the lender has, by its conduct, *waived* its rights under the due-on clause regarding the further encumbrance carried back by the seller, a separate event itself triggering the due-on clause. [**Rubin** v. **Los Angeles Federal Savings and Loan Association** (1984) 159 CA3d 292]

However, the lender has not entered into a written agreement waiving its due-on right to **call or recast** the loan should the buyer later transfer an interest in the property while the carryback seller still holds his second trust deed, or the seller forecloses and becomes the owner of the property again.

After the buyer takes title to the property, a transfer of any interest in the secured real estate by the buyer will require the lender's prior consent to avoid triggering the due-on clause, except for a lease with a term under three years and the personal residence exceptions.

On the later transfer of any interest by the buyer, the lender has the right on each transfer to:

- **accelerate** (call) the balance of the loan; or
- **recast** the loan, demanding modifications of the note and a fee as a condition for allowing an assumption or other waiver of the due-on clause.

The underlying lender can call the loan or demand the note to be recast, with exceptions for conveyance of the personal residence to family members or for any equity loan encumbrance, if, after escrow closes, the buyer:

- dies;
- conveys or further encumbers the property;
- enters into a long-term lease or a lease with a purchase option; or
- defaults on the carryback note and causes the seller to complete a foreclosure sale, etc. [See Chapter 11]

The written waiver as protection

A typical carryback sales transaction is structured as either:

- a **regular** trust deed and note with the underlying lender consenting to the conveyance of the property and the recording of a carryback second trust deed by waiving its due-on clause in exchange for an assumption fee and modification of the note **by the buyer**; or
- an **all-inclusive trust deed** (AITD) and note, or another wraparound security device, with the underlying lender consenting to the conveyance to the buyer and the carryback AITD by waiving its due-on clause in exchange for a modification of the trust deed note and payment of fees **by the seller** — all in lieu of the buyer's assumption of the loan, an activity sometimes called a *reverse assumption*.

After the lender consents to the carryback sale and escrow closes, future events beyond the seller's control can again trigger the due-on clause.

A carryback seller, like any junior trust deed holder, must be made aware and understand a due-on clause in the underlying trust deed gives the lender the absolute right to call the loan on a **future transfer of any interest** in the property by the buyer. The lender's call is restricted only on short-term leases on any type of property, and on inter-family transfers and the further encumbrance of owner-occupied, four-or-less unit residential properties.

Without the lender's **prior written waiver** of its due-on enforcement rights, triggered by future transfers, the lender can call the loan due on a later transfer of any interest in the property by the buyer, such as a resale, further encumbrance, lease for over three years, court ordered transfer, foreclosure, death, etc. (with some exceptions for the principal residence).

A written waiver of the lender's **future enforcement** of the due-on clause bars the lender from calling the loan and protects the carryback seller for so long a time as the seller has an interest in the property. The **waiver agreement** assures the carryback seller he can protect his security interest in the title without due-on interference from the underlying lender. [See Form 410 accompanying this chapter]

When a secured property is sold and the seller accepts a second trust deed without receiving the lender's prior written consent, the due-on clause has been breached under federal mortgage law. Thus, no duty is imposed on the first trust deed lender to avoid subordinating the interest of the holder of the unconsented-to junior lien by recasting the first trust deed note. [**Friery** v. **Sutter Buttes Savings Bank** (1998) 61 CA4th 869]

To best protect the seller's trust deed, the seller should have the lender waive its right to call the loan:

- on the conveyance and further encumbrance of the property on the close of the carryback sale;
- for as long a period as the carryback trust deed remains of record; and
- on the carryback seller's reacquisition of title to the property should the seller have to complete a foreclosure on the property or accept a deed-in-lieu of foreclosure.

To be enforceable against the lender, the waiver must be in writing. [12 Code of Federal Regulations §591.5(b)(4)]

FURTHER ENCUMBRANCE CONSENT

DATE:_____________, 20______, at ____, California.
Items left blank or unchecked are not applicable.

FACTS:

1. This consent agreement is entered into between

1.1 ____, as the Existing First Lender,
1.2 and ____, as the New Junior Lender,
1.3 regarding the Existing First Lender's trust deed recorded on ____________________________,
as Instrument No._________________, in _____________________________ County Records, California,
1.4 executed by ____, as the Trustor,
1.5 in which ____ is named as the Beneficiary,
1.6 encumbering property referred to as ____
____.

2. A trust deed, junior and subordinate to the Existing First Lender's trust deed, will be executed in favor of the New Junior Lender in reliance on this consent agreement.

AGREEMENT:

3. The Existing First Lender hereby:

3.1 Consents to the further encumbrance of the property in favor of the New Junior Lender.

3.2 Waives its due-on rights until the New Junior Lender's trust deed encumbrance is reconveyed or foreclosed and no longer is a lien on the property.

3.3 Waives its due-on rights should the New Junior Lender later acquire title to the property by foreclosure or deed-in-lieu of foreclosure under its trust deed, subject to the following checked conditions at the time of transfer:

a. ☐ Payment of an assumption/transfer fee of $_____________.

b. ☐ Modification of the Existing First Lender's note to reflect interest at the fixed rate of ______% per annum, amortized over the loan's remaining term, with the principal balance due _____________, 20______.

c. ☐ ____.

4. GENERAL PROVISIONS:

4.1 All other provisions of the Existing First Lender's trust deed remain unaffected by this consent.

4.2 This consent is for only one further encumbrance by the New Junior Lender.

4.3 This consent inures to the benefit of the successors and assigns of the parties.

NOTE: The following agreements are used when an existing second trust deed will remain of record after further encumbering the property.

5. SUBORDINATION AGREEMENT to any modification agreed to in Section 3.3 above.

5.1 _________________________ is the Beneficiary under a second trust deed lien on the property recorded as Instrument No. _______________, in _______________________________ County Records, California.

5.2 The Existing Second Trust Deed Beneficiary consents to this modification and agrees to subordinate his trust deed to these modifications on demand.

5.3 The Existing Second Trust Deed Beneficiary consents to this further encumbrance and waives enforcement of any due-on clause in its trust deed.

5.4 The Existing Second Lender is____.

Date:____________, 20______. Signature of Existing Second Lender:____________________________________

EXISTING FIRST LENDER:

I agree to the terms stated above.

Lender: ____
By:____
Signature: ______________________________________
Title:____

NEW JUNIOR LENDER:

I agree to the terms stated above.

Lender: ____
By:____
Signature: ______________________________________
Title:____

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AITD, waiver and reverse assumption

The all-inclusive trust deed (AITD) carryback is merely a variation on the standard carryback second trust deed. An AITD is also a junior trust deed, typically a second.

However, in contrast to the standard trust deed, the AITD:

- secures a note for a principal amount which totals the unpaid balances on underlying liens and the balance of the seller's equity remaining unpaid after a down payment;
- obligates the carryback seller to remain responsible for making payments on the underlying liens; and
- does not involve an **assumption** of the underlying (wrapped) loan by the buyer.

However, the creation of the AITD, recorded or not, still triggers the due-on clause, as does a grant deed, since it is a further encumbrance of the real estate.

Prior to closing an AITD sale, it is **the seller**, not the buyer, who negotiates the modification of the existing first trust deed note and arranges for the payment of any fees demanded by the lender to waive the due-on clause. The note modification by the seller increases the lender's portfolio yield through an increase in interest rates and the amount of monthly payments, as if the buyer had assumed the loan. A modification fee will be demanded of the seller in lieu of a buyer's assumption fee.

Thus, the lender of record receives the same economic benefits of fees and market rates on the seller's modification of the loan as though the buyer had assumed and modified the loan, called a *reverse assumption*.

In exchange for the fees and modification, the lender consents to the seller's AITD financing. As part of the negotiations, the lender agrees in writing to waive its rights under the due-on clause for as long as the carryback seller holds an interest in the property.

The seller carrying back an AITD retains the responsibility for paying the principal and interest installments and any impounds due the lender on the underlying loan. Thus, the **credit review** of the buyer by the lender is avoided since the seller remains the sole party responsible for payment.

After closing, instead of the buyer making payments on the underlying loan, the buyer makes installment payments on the AITD note directly to the carryback seller. On receiving installment payments on the AITD note from the buyer, the carryback seller pays the installment due on the underlying trust deed and keeps any remaining amount as his funds.

Broker's duty to disclose risks

A broker negotiating the carryback of a junior trust deed by a seller must inform the buyer and seller of the risks posed by the due-on clause in the underlying loan. After a review of the due-on risks, the transaction is structured for the buyer to either:

- obtain the consent of the lender to the transfer and carryback financing, called a *waiver*; or
- take title *subject to* the existing trust deed. [See **first tuesday** Form 150 §5]

Additionally, the carryback seller must understand a default by the buyer on installments on the all-inclusive trust deed (AITD) note will force the seller to advance the delinquent installment to the underlying lender. If the installment is not advanced, the seller risks having his AITD wiped out by the

lender's foreclosure, a result no different then if the seller had carried back a regular second trust deed note.

The broker's failure to **investigate** the provisions in a trust deed which is to remain of record, whether payments remain the seller's responsibility or become the buyer's, and **advise** the seller and the buyer of the existence and nature of any due-on clause. If the broker fails to do so, he is liable to both the buyer and seller for any due- on related loss of their financial expectations.

For example, a buyer who is qualified to make payments on both the existing trust deed and a carryback note presents an offer to purchase property through the seller's listing broker.

The purchase offer provides for a small cash down payment with the buyer taking title **subject to** the existing trust deed. The seller is to carry back a note for the balance of the purchase price and the seller accepts the offer.

However, the buyer is not advised the recorded trust deed contains a due-on clause. Since an assumption of the loan by the buyer will not occur, a beneficiary statement is not ordered. A beneficiary statement would have disclosed the existence of the due-on clause to the buyer prior to closing, as would a copy of the recorded trust deed. [Calif. Civil Code §2943]

After escrow closes, the first trust deed lender discovers the sale and calls the loan due. The buyer, unable to pay the balance due on the first trust deed, ultimately loses the property through a foreclosure sale under the first trust deed.

The buyer seeks to recover his lost value from the seller's listing broker, claiming the broker had a duty to investigate and disclose the existence of the due-on clause.

The broker claims he owed no duty to the buyer to investigate or disclose title conditions contained in the recorded trust deed since the buyer was not his client.

Can the buyer collect his losses from the seller's listing broker?

Yes! Any broker negotiating a transaction as an agent for either party must disclose title conditions affecting ownership or use of the property to both parties, not just his client.

A due-on clause in a trust deed is a title condition directly affecting ownership of the real estate. The clause affects the buyer's ability to maintain financing for the acquisition and continued ownership of the property. Thus, the seller's broker has a general duty to disclose the existence of a due-on clause to both parties involved in the transaction. [**Pepitone** v. **Russo** (1976) 64 CA3d 685]

Waiver negotiations by the broker

A seller's listing broker can lessen the seller's risk of loss on a carryback sale by negotiating and obtaining a written waiver of the existing lender's future due-on rights prior to closing the transaction.

The broker negotiating the carryback sale structured as an all-inclusive trust deed (AITD) or other wraparound financing agreement, also needs to anticipate the parameters of the lender's demand for increased interest and payments in exchange for a waiver of its due-on clause.

The interest rate and payment schedule negotiated for the AITD note should **equal or exceed** the interest rate and payment schedule the existing lender will demand as a modification of its note in exchange for its consent to the sale and any waiver of the lender's future use of the due-on clause.

If, at the time the AITD carryback sale is negotiated, market interest rates are the same or lower than the interest rate on the underlying loan, the lender will be inclined to retain the original rate and demand only an assumption fee, often expressed in terms of points, for consenting to the seller's AITD sales transaction.

Conversely, in a market of rising interest rates when the existing lender's note rate is below market interest rates, the lender is certain to use the due-on clause to take advantage of the higher current rates and increase the note rate, and their yield, on the buyer's assumption or on the seller's modification in the case of an AITD transaction.

The AITD purchase agreement should specify the terms for modification of the existing loan which are acceptable to both the buyer and the seller, placing limitations on the interest, monthly payments, due date, and assumption fee to be negotiated by the seller with the lender. Alternatively, the purchase agreement can include a contingency for the seller's further approval of the modification demands by the lender to avoid impairing his AITD.

The carryback seller or his broker will need to negotiate the assumption or modification agreement with the lender, as well as any waiver of the lender's exercise of its due-on rights for as long a period as the seller retains an interest in the property.

Chapter 13 — Working the AITD and note

This chapter reviews the advantages of a carryback all-inclusive note and trust deed (AITD), the terms to be negotiated and the forms to be used.

Flexible carryback financing

As a *debt instrument* and *security device* for the credit sale of encumbered real estate, the all-inclusive note and trust deed (AITD) provides agents, sellers and buyers with the flexibility needed during periods of tightened availability of mortgage funds to finance the **balance of a sales price** remaining unpaid after a down payment.

For a buyer, the AITD note carried back by a seller is all the financing needed to acquire encumbered real estate with a down payment. The principal amount of the AITD note includes:

- the seller's **remaining unpaid equity** in the property; and
- the **unpaid balance** on the existing loan which will remain of record, called the *wrapped loan* or *underlying loan*.

The buyer makes monthly payments to the seller on the AITD note. In turn, the seller makes monthly payments to the underlying lender.

The advantages of an AITD note over a regular second trust deed note are mainly felt by the seller. However, the buyer, seller and lender benefit since the buyer does not assume the wrapped loan.

For the benefit of the seller, the AITD note:

- **allows a greater yield** than could be negotiated on a regular second trust deed note, a financial advantage due to the AITD note's *overriding interest rate* feature;
- **reduces the risk of loss** due to a default on the underlying loan since the seller remains responsible for payments on the underlying loan;
- **defers profit tax liability** for a greater percentage of the transaction's profit taxes since the AITD note increases the percentage of profit allocated to the principal in the carryback;
- **supports the price** sought by the seller by providing financing; and
- **provides for a trustee's foreclosure** on the buyer's default, unlike other wraparound security devices, such as land sales contracts and purchase/lease-option agreements which require a judicial foreclosure (unless they contain a power- of-sale provision).

As a benefit to the buyer, the AITD note provides more simplicity and flexibility than conventional or government insured loans, since:

- the interest rate and payment schedules are **fully negotiable** and not tied to secondary money market standards;
- the carryback seller is less concerned with **creditworthiness** and income ratios than standardized institutional lenders due to the seller's intimate knowledge of the security;
- the buyer makes payments on only one debt, the AITD note; and
- no third-party lender fees are required, such as points, garbage fees, private mortgage insurance (PMI), assumption fees or a separate lender's American Land Title Association (ALTA) title insurance policy.

AITD concept of wraparound financing

An all-inclusive trust deed (AITD) is always a **junior trust deed**, usually a second, subordinate to a pre-existing, underlying first trust deed. Legally, the AITD has the same function as a regular trust deed since it is physically the same as a trust deed form, except for an AITD addendum covering the disclosures and accounting for the all-inclusive wraparound aspect.

Land sales contracts and lease-option sales are also all-inclusive security devices and they exhibit the same wraparound debtor/creditor features as an AITD. In all three — AITD, land sales contract and lease-option sale — the seller has sold the property and remains responsible for payments on the underlying loan while receiving installments from the buyer. Income and property tax results are the same for each device among all government agencies.

Terms of the AITD note

The terms negotiated for payment of the sales price when the seller carries back an all-inclusive trust deed (AITD) note include five variables:

- the down payment;
- the amount of the AITD note;
- the interest rate;
- the periodic (monthly) payments; and
- the due date.

Down payment is unaffected by AITD

The down payment in an all-inclusive trust deed (AITD) carryback note transaction is handled no differently than on any other method of carryback financing, such as a regular first or second trust deed, land sales contract or lease-option sale. The amount of the down payment is fully negotiable between a buyer and seller, and can range from zero to the seller's entire equity in the property.

The prudent carryback seller will require a down payment of no less than 10% to 20% of the sales price depending on whether the property is sold as income producing property or a buyer-occupied single family residence (SFR). The smaller the down payment, the greater the risk of loss for the seller should the buyer default and the property be repossessed and resold. The risk caused by a low down payment is covered financially by:

- an increase in the price or interest rate, or both;
- cross collateralization by a lien on additional property; or
- the bifurcation of the carryback debt into separate secured and unsecured debts.

Amount of the AITD note

The most distinctive characteristic of the all-inclusive trust deed (AITD) note is its *face amount*. The **face amount** of the AITD note includes the unpaid balance on any underlying encumbrances which remain the responsibility of the seller to pay, **plus** the seller's equity remaining unpaid after a down payment. Viewed another way, the AITD note is the balance of the sales price remaining after the down payment. [See Form 421 in chapter 15]

At first glance, the total dollar amount of the debts secured by the underlying trust deed and the all-inclusive carryback trust deed appear to over-encumber the property.

However, the amount of the AITD note **wraps around** and is **inclusive** of the underlying loan balance. Thus, the separate trust deed balances cannot be added together to determine the total dollar amount of encumbrances on the property. The amount of the AITD note is most frequently the total amount owed on **all** encumbrances.

For example, property encumbered by a $60,000 first trust deed is sold for $100,000 with a $30,000 down payment. An AITD note is carried back for $70,000, the amount remaining unpaid on the purchase price, and the buyer does not agree to pay the first trust deed. Collectively, the amounts secured by the two trust deeds total $130,000, yet the amount required to clear title of both trust deeds is only $70,000, the amount of the AITD note.

Conversely, a **regular** trust deed note carried back as a second for the balance of the seller's equity (after the down payment) would have been for $10,000, with the buyer assuming the $60,000 first trust deed, leaving an aggregate debt of $70,000.

The minimum dollar amount the seller can carry back on an AITD is the total amount of the underlying loans for which the seller remains responsible. The AITD note must be mathematically structured so that it has a remaining **principal balance** equal to or greater than the remaining balance on the wrapped loans at all times.

However, an AITD need not include all pre-existing trust deeds or other loans recorded against the property sold. The AITD may be a third trust deed which wraps only the second and not the first, or vice versa. The buyer takes over payments on the existing trust deed loan which is not included in the AITD amount, with the seller remaining responsible for the second lien (which may be a judgment or a loan with an interest rate unacceptable to the buyer).

When only one of two existing loans is wrapped, the dollar amount of the AITD note is for the remaining balance of the purchase price after deducting both the down payment and the balance of the one loan taken over by the buyer.

The interest in alternatives

Use of an all-inclusive note and trust deed (AITD) by a seller can make attractive financingfor buyers during periods of high interest rates by offering a **below-market rate**, whether or not the underlying note rate is below market.

For the seller, the interest rate on the AITD note will preferably, but will not always, equal or exceed the rate on the underlying note.

In this respect, the AITD rate is said to *override* the rate on the underlying trust deed note. The override is the difference between the interest rate on the underlying trust deed note and the higher rate negotiated for the AITD note.

For example, an AITD note with a 10% rate which wraps a first trust deed note at 7% gives the seller a 3% interest **override** on the underlying loan balance.

The override is the financial advantage available to the carryback seller when using an AITD, as it can greatly increase the yield on his equity in the AITD note. [See Chapter 21]

If the interest rate on the underlying loan **exceeds** the interest rate on the AITD, the seller's equity in the AITD is said to *burn-off* bit by bit, shrinking daily as interest accrues in dissimilar amounts on each trust deed note.

This principal burn-off reduces the seller's equity in the AITD. More importantly, the AITD note balance will reduce faster than the balance on the underlying loan, converting cash received as principal payments on the AITD into interest paid on the wrapped loan. As a result, a due date on the AITD must be set for payoff before the balance on the AITD note sinks below the balance on the wrapped loan, called a *crossover*.

Wrapping a variable rate loan

The seller wrapping a variable rate loan/adjustable rate mortgage (ARM) with an all-inclusive note and trust deed (AITD) should conform the interest rate provisions in the AITD note to the rate adjustment provisions in the underlying ARM. The same index, adjustment periods, floor and ceiling rates, and payment schedules should be included in the AITD note, making the AITD an ARM.

For example, an owner decides to sell real estate encumbered by an ARM. The ARM has a note rate comprised of the 11th District cost- of-funds and a margin rate of 2.5%. By using the same index and a **margin equal or greater** than on the underlying loan, the seller will receive sufficient interest to service the first trust deed without reducing the seller's return on the all-inclusive ARM, resulting in no **principal burn off**.

When the seller uses the same index on the AITD note as the index used on the underlying loan, but negotiates a greater margin, the seller receives additional **overriding interest** on the portion of the AITD note equal to the balance on the underlying loan.

A carryback seller should not use a different index on the all- inclusive ARM than the index used on the underlying loan. If a different index is used, the index for the carryback could fall while the index on the underlying loan rises, leaving the seller to pay the difference.

Also, a seller can wrap a fixed-rate loan by carrying back an all- inclusive ARM. The adjustable rate provision included in the AITD note would set the life-of-loan *floor rate* at no less than the fixed rate on the underlying loan. Thus, the seller prevents the interest rate on the all-inclusive ARM from falling below the rate on the underlying fixed-rate loan.

Payments and contract collection

In a typical all-inclusive note and trust deed (AITD) transaction, the buyer makes installment payments on the AITD note directly to a seller. The seller then makes the scheduled payments owed to the underlying senior lender. The seller retains the difference as his net cash flow on the AITD note.

A *contract collection* account can be entered into by the seller to receive payments and make disbursements to the underlying lender. Under contract collection, a bank, thrift, escrow or broker will collect and disburse the monthly payments called for in the AITD note. [See **first tuesday** Form 237]

Contract collection is convenient. However, if the seller and the buyer **mutually agree** that the seller will place the AITD note on contract collection, the agreement will severely reduce the deferral of profit tax on the installment sale. The collection agent is deemed to be the agent of the buyer when agreed to by the buyer and the seller. When payments are made by the buyer's agent, the responsibility for payments on the underlying loan is attributed to the buyer.

Due to the shift in responsibility created by a mutually agreed to contract collection account, the seller has **debt relief**, increasing the profit-to-equity ratio on the installment sale and increasing the percentage of down payment and principal payments reported annually as profit. [**Goodman** v. **Commissioner of Internal Revenue** (1980) 74 TC 684]

The buyer's monthly payments on the AITD note may be in any amount. However, prudence suggests the payments will be no less than the amount the seller must pay on the underlying note, even if good reason exists for a lesser payment.

Also, the flexibility available with the AITD note allows for payment schedules to be negotiated which are attractive to buyers.

For example, young buyers, whose rising incomes will allow them to make larger payments in the future, might be able to purchase the seller's property if a *graduated payment program* allows them to initially afford payments to buy the property.

Graduated monthly payments allow buyers to make monthly payments which start out low, but gradually increase from year to year. For instance, a buyer who cannot currently afford what should be a monthly AITD payment of $2,000 could offer to pay $1,400 monthly for the first year. With the agreement of the buyer and seller, the monthly payments could be increased annually by $200, until the full $2,000 amount needed to amortize the AITD is reached.

However, the low monthly payments may be insufficient to cover the accrual of a fixed rate of interest on the AITD note. A provision can be included in the note calling for any accrued and unpaid interest to be added to the principal, called *compounding*.

Thus, until the buyer's monthly payments increase enough to cover the accruing interest, the principal amount of the note will increase, an accounting situation called *negative amortization*.

Rather than adding interest to the principal, a provision for an additional installment could be negotiated and added into the note calling for an additional payment on a future date of all accrued interest which remains unpaid.

For an alternative to **negative amortization** under the fixed rate, a *graduated rate* of interest could be charged which is consistent with the graduated payment schedule.

Another tax consideration for carryback sellers is the use of a *prepayment penalty* provision to induce the buyer into paying no more than the amount of the scheduled monthly payments for an agreed-to period of years. Any early payoff of additional principal during the enforcement period will include a prepayment penalty. Prepayment penalties are limited on one-to-four unit residential properties.

A prepayment penalty should be a sufficient amount to provide funds for the seller (on other than one-to-four units) to cover the tax liability incurred on the premature termination of the installment sale due to an early payoff.

Payoff amounts vary by formula used

Two types of all-inclusive trust deeds (AITDs) exist, including:

- an *equity payoff* AITD [See Form 442 in chapter 15]; and
- a *full payoff* AITD. [See Form 443 in chapter 15]

With an **equity payoff** AITD, reconveyance occurs when a seller's equity in the AITD — the principal amount of the AITD note remaining after deducting the underlying loan balance — is fully paid. [See Form 442 in chapter 15]

Once the seller receives the payoff for the equity amount in his AITD and reconveys, the buyer becomes responsible for installment payments on the underlying trust deed note. The underlying trust deed is not

paid off and remains of record, the buyer having previously taken title subject to the loan.

Full payoff AITDs require payment of the entire balance on the AITD note — which includes amounts owed on the underlying loan — before reconveyance can occur. Thus, both the AITD and the underlying trust deed are fully satisfied and reconveyed on payoff of the AITD. The full payoff AITD is less financially flexible for the buyer when arranging for a payoff. [See Form 443 in chapter 15]

Taxwise, the full payoff AITD is preferable for the seller. The full payoff AITD note, without a contract collection provision, provides for no debt relief at any time. The buyer can never take over the responsibility for the underlying loan, even on final payoff and reconveyance of the AITD. Thus, the full payoff AITD allows the seller to use the installment sales method of income tax reporting without the issue of debt relief ever arising. [See Chapter 13]

The due date for an AITD note can be set at any length of time, ranging from the first of the next calendar year to 15 years or more. However, the due date of the AITD note should fall on or before any due date on the underlying loan.

For example, if an underlying loan is due in three years and the AITD in five, the seller will be required to pay off the underlying lender before he is paid off on the AITD.

In this scenario, the seller could pass the payoff burden to the buyer by including a special additional installment on the AITD note. The payment would be sufficient in time and amount to meet the final/balloon payment on the underlying loan. The alternative is to set the due date on the AITD to no later than the date of the final/balloon payment on the underlying loan.

Also, an amortization schedule which reduces the AITD note balance to an amount equal to the wrapped loan requires a due date on or before the date by which both notes will have the same remaining principal balance. Thus, the seller avoids liability for a reduction in the AITD note below the amount of the wrapped loan.

Pass-through clause protection

An all-inclusive trust deed (AITD) also contains *pass-through provisions* to cover charges demanded by the underlying lender. [See Forms 442 §5 and 443 §6 in chapter 15]

For instance, the buyer may wish to refinance and pay off the AITD note and the underlying loan before they come due. With a **pass- through provision** in the AITD addendum, the buyer will fund any prepayment penalty the underlying lender is entitled to for early payoff, not the carryback seller, even though the seller is primarily responsible for paying principal and interest on the underlying debt.

Also, if the underlying lender demands payment of any late charges, future advances or the entire loan balance brought about by the buyer's conduct, the payment of the demands is passed through to the buyer.

Due-on hazards of interference

A lender holding a trust deed which contains a due-on clause can call the loan balance due on the transfer of almost any interest in the property. The due-on clause is called an *alienation clause* since it is triggered by transfers, and the call is referred to as an *acceleration* of the note balance.

The **due-on clause** in an all-inclusive trust deed (AITD) is triggered by:

- any conveyance of ownership, including land sales contracts;
- origination (except home equity loans) or foreclosure of junior trust deeds on the property; or
- the creation of a lease for more than three years, or any lease with an option to buy. [12 Code of Federal Regulations §591.2(b); see Chapter 11]

The carryback AITD transaction involves both a sale (the grant deed) and a further encumbrance (the trust deed).

Thus, an AITD transaction triggers the due-on clause in any underlying trust deed which allows the lender to:

- call or recast the loan, unless they have given written consent to the sale; or
- fail to act on the right to call the loan after notice of the transaction, called a *waiver*.

When current market interest rates are high and the AITD is most beneficial to both the buyer and seller, the senior trust deed lender is likely to call the underlying loan due on sale. Alternatively, the lender might demand the loan be recast at current market rates (including modified payments to retain the same amortization period and fees for doing so), or the lender may do nothing at all.

Consider an AITD buyer who takes title subject to the underlying loan — the buyer **does not assume** the seller's obligation to pay the loan at the time of the sale. No lender consent to the carryback sale is sought or obtained by the seller.

Under the terms of the AITD, the seller agrees to hold the buyer harmless from all obligations which exist on the underlying loan. [See Forms 442 §1 and 443 §1 in chapter 15]

Thus, the buyer is **held harmless** (by the seller) against any activities of the underlying lender, unless:

- the **buyer interferes** by triggering the due-on clause through further encumbrance, long-term lease, resale, waste, etc; or
- a **pass-through provision** in the AITD shifts the due-on- sale burden to the buyer, as with late charges, prepayment penalties or future advances.

Payments made as payments received

A seller's primary duty is to make all the payments due on the underlying loan, as long as the all-inclusive trust deed (AITD) remains of record and the buyer is not in default.

If a buyer fails to make payments on the AITD note, the seller is under no legal obligation to forward his own funds to the underlying lender, or to protect the property from a foreclosure under the first trust deed.

Even without the obligation to keep the first trust deed current, the AITD seller may feel compelled by the buyer's default to advance funds to keep the underlying trust deed current. If he does not, he risks allowing his AITD to be wiped out by the underlying lender's foreclosure.

If the underlying lender calls the loan based on the AITD transaction, the seller may be forced to use his own funds or borrow against other assets (or collateralize the AITD) to pay off the lender. Thus, the buyer must agree in advance to cooperate with the seller should the first trust deed be called due and it becomes necessary for the buyer to sign documents to refinance the real estate to fund the payoff.

If possible, prior arrangements should be made with senior lenders to prevent due-on enforcement during the term of the AITD, called a *reverse assumption*.

AITD documentation

The all-inclusive trust deed (AITD) transaction should be documented:

- between a buyer and seller with a purchase agreement, escrow instructions, grant deed, trust deed and note;
- between a seller and lender with a due-on waiver and any modification of the underlying note agreed-to with the lender for consent; and
- with escrow, by the buyer depositing the downpayment funds and the all-inclusive note and trust deed, and the seller depositing his grant deed.

Agents must make full disclosure to the buyer and the seller about the terms of the carryback and the underlying financing. Disclosure is accomplished in part by use of the AITD addendum. Further, a carryback financing disclosure form with statutorily mandated content is to be used on carryback sales of one-to-four unit residential property and, as good practice, on the carryback sale of all other types of property. [See Chapter 3]

Buyer NODq protection

A buyer and the buyer's agent must be sure the terms of the all-inclusive note and trust deed (AITD) are consistent with the underlying senior note and trust deed it wraps.

To assure consistency, escrow should be instructed to order a *beneficiary statement* from the existing trust deed lender. A lender's **beneficiary statement** confirms the terms of the underlying encumbrance are as represented by the seller. The statement enables the buyer to confirm the consistency of the terms in the underlying loan and the AITD. [See **first tuesday** Form 429]

The buyer should also consider having the seller agree to **record and serve** the underlying lender with a *Request for Notice of Default* and *Notice of Delinquency* (NODq) on the underlying trust deeds. [See Form 412 in chapter 5; see Chapter 5]

The request for an NODq assures the buyer he will promptly learn of any failure by the carryback seller to make payments to senior lienholders. [Calif. Civil Code §§2924b, 2924e]

Editor's note — A carryback seller who fails to pass AITD payments on to the wrapped lender exposes himself to criminal sanctions.

PIQWOP risks in a blanket encumbrance

Finally, a buyer or his agent should check the preliminary title report to find out if the underlying trust deed is a **blanket encumbrance** which also affects property other than the property in question.

All-inclusive trust deeds (AITDs) are sometimes used by undercapitalized developers and land sales promoters. With the AITD, they can finance the sale of real estate lots which have been cut out of a larger parcel when the larger parcel is encumbered by a blanket trust deed which may lack a partial release clause.

For their purpose, these developers and promoters use an AITD which only discloses that "underlying loans may or may not exist."

Typically, in these cases of blanket encumbrances, no disclosure is made of the amount or terms of the underlying loan, nor of the existence of the blanket trust deed on the *parcel in question with other parcels* (PIQWOP).

If the seller defaults on a blanket trust deed which lacks a partial release clause, the buyer of a real estate lot on an AITD would have to pay off or refinance the entire blanket trust deed to protect himself. Paying off or refinancing the entire blanket trust deed is an economically unlikely possibility when, as in most cases, the underlying loan balance exceeds the AITD balance (and the price paid for the individual lot). [**Drake** v. **Martin** (1994) 30 CA4th 984]

Chapter 14 — The AITD's leveraged yield

This chapter presents the evaluation of the annual yield a carryback seller receives on his equity in an all-inclusive note, and addresses due date aspects of a reverse all-inclusive trust deed.

The carryback environment

Consider a property encumbered by an existing trust deed which secures a note with a balance of $600,000, payable monthly, including 7% interest, until fully amortized in 26 years.

The owner of the property would like to cash out his equity without reducing the sales price of the property to below $1,000,000.

However, an inflationary economy and an over-active real estate market have brought on a corrective credit crunch, making it difficult for buyers with modest down payments to obtain financing from conventional lenders.

Accordingly, the owner agrees to list the property on sales terms which include a 20% down payment and a carryback note for the **balance of the purchase price**, called an *all- inclusive note and trust deed* (AITD).

The AITD will "wrap" the seller's existing **underlying loan**. Specifically, the principal amount of the AITD note will include the amount of the $600,000 principal balance remaining on the underlying loan.

AITD equity above the wrapped loan

Consider an example where a seller carries back an all-inclusive trust deed (AITD) note for $800,000, bearing an 8% interest rate with monthly payments amortized over 30 years, all due in seven years. The **seller's equity** in the AITD note is the difference between the $800,000 AITD and the $600,000 balance remaining on the first trust deed — a $200,000 equity in the AITD at the time of closing.

The seller receives 8% interest on the entire amount of the $800,000 AITD note. In turn, the seller pays the underlying lender 7% interest on the $600,000 first trust deed loan.

The AITD interest rate override

During periods of higher interest rates for mortgages than rates available during the prior 18 to 24 months, a carryback seller can offer a below market rate on an all-inclusive trust deed (AITD) note and actually yield a greater return on his equity in the AITD note than the current rate charged for mortgage loans.

The spread between the interest rate on an underlying loan and the AITD note is called an *overriding* interest rate. The AITD has an interest rate override on the underlying loan (in our example 1%, 8% minus 7%).

The spread in the **override** between the interest rates accrues to the benefit of the seller. The interest rate override raises the **effective yield** on the AITD's equity above the AITD note rate, the result of *leveraging* (ratio of the underlying loan balance to the AITD equity).

However, this **leveraging** ability is hindered by the seller's need for the first trust deed lender's consent under its due- on clause in the wrapped trust deed.

For the carryback seller, the AITD with its interest override can be compared to a private lender borrowing money from a bank at one rate (the rate on the underlying trust deed loan) and lending the funds to buyers of real estate at a higher rate (the rate on the AITD).

In our example, the seller receives annual interest on his AITD of $64,000 (8% of $800,000). In turn, he pays the underlying lender $42,000 in interest (7% of $600,000). Thus, the seller's net annual interest income equals $22,000 during the first 12 months.

The $22,000 net interest income is the seller's annual interest income earned on his $200,000 AITD equity, resulting in an 11% yield.

The AITD equity allows the seller to receive a greater return than the trust deed note rate, called the *effective rate of return* on the AITD note.

Editor's note — The equity leverage on the 1% override on the existing debt is 600,000:200,000, or 3:1. Hence, the 1% override becomes an additional 3% yield on the equity in the AITD — a yield added to the 8% AITD note rate on the $200,000 equity in the AITD. Thus, the effective rate of return on the $200,000 equity in the AITD note is 11% (3% plus 8%).

The effective rate of return

The **effective rate of return** on a seller's equity in an all-inclusive trust deed (AITD) note is calculated using the principal amount of the underlying trust deed note, the equity amount in the AITD note and the interest rate spread between these two notes.

The mathematical formula to use with a financial calculator is:

- enter the amount of the underlying loan balance;
- ÷ equity in the AITD note;
- x the interest rate spread between the underlying loan and the AITD note;
- + the interest rate on the AITD note;
- = the yield on equity in the AITD note.

Thus, the seller's yield on the AITD equity in our previous example is:

- $600,000 underlying loan balance;
- ÷ $200,000 AITD equity;
- x 1% interest override;
- + 8% AITD note rate;
- = 11% yield on AITD equity.

The $800,000 AITD note carried back at an interest rate of 8% gives the seller the same yield as if the buyer assumed the underlying loan and executed a seller carryback note for $200,000 at 11%.

However, the AITD gives the seller a great psychological advantage over the typical buyer. With an AITD, the buyer can boast about the lucrative financing he negotiated with the seller.

The buyer has obtained maximum financing and pays 8% interest, with no points or garbage fees. Conversely, if the buyer executed a second trust deed note for $200,000 at 11% interest, he would have

nothing to brag about, even though he would have taken over a first trust deed note at 7% and be paying the same overall amount of annual interest on the two encumbrances as he would have at the 8% rate on the AITD note.

Conflicting amortization periods

The yield calculation for the effective rate of return on an overriding all-inclusive trust deed (AITD) note sets the yield at the time of sale. However, the **effective interest yield** on the AITD note will vary following each payment throughout the life of the AITD.

When the amortization periods for both the AITD note and the underlying loan are the same, the amount of equity in the AITD note decreases gradually until the principal on the AITD and the underlying note is fully paid.

With the amortization periods the same on both notes, the effective **rate of return decreases gradually** over the life of the AITD since the ratio of the AITD equity to the balance remaining on the underlying loan decreases. [See Figure 1]

More dramatically, when the underlying loan amortizes over a **shorter period** of time than the AITD, the equity in the AITD note increases from month to month while its annual **rate of return decreases**. Earlier principal payoff on the underlying loan decreases the AITD leverage, causing the seller's equity in the remaining balance on the AITD note to increase and the effective rate of return to decrease until the underlying loan is fully paid. [See Figure 2]

Shrinking equity in the AITD

When the underlying loan is amortized over a longer period of time than the period of amortization for the all- inclusive trust deed (AITD), the equity in the AITD decreases and the effective **rate of return increases**. The principal due on the AITD note is amortized (by payments) over a shorter period than the underlying loan.

Thus, the seller's equity in the AITD note decreases from month to month, until **no equity remains** in the AITD. Consequently, the increasing leverage causes the effective yield on the seller's equity in the AITD to increase from month to month, until there is a **cross-over** in the note balances. [See Figure 3]

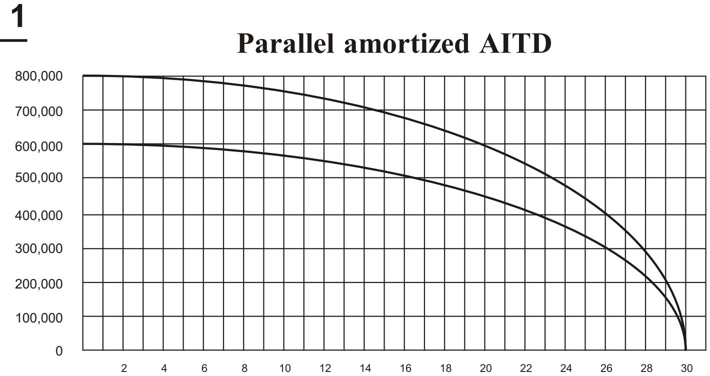
Accordingly, the AITD note which produces a **shrinking AITD equity** must contain a **due date** by which it will be satisfied and reconveyed. The due date must be scheduled to occur before the date the AITD balance has been reduced below the remaining balance on the underlying loan.

An AITD note with a **shrinking equity** must have a due date which is scheduled to occur before the AITD balance drops below the balance remaining on the underlying loan. Further, the AITD must be reconveyed prior to the cross-over of note balances. If not, the seller is **contractually liable** for the amount of the underlying loan which exceeds the balance of the AITD note when the AITD is eventually reconveyed. [See Figure 3]

Yield when wrapping two loans

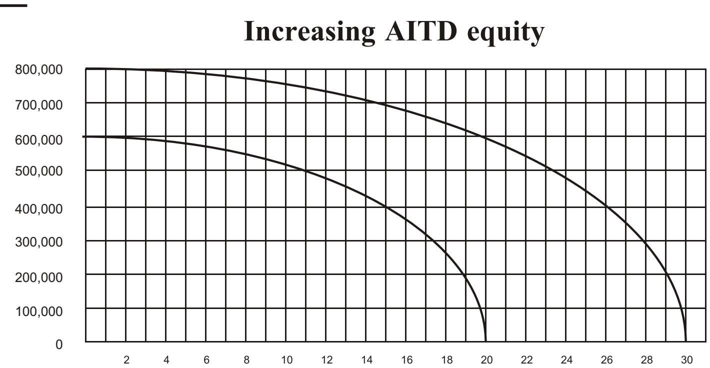
Occasionally, a seller's property is encumbered by more than one loan. Two or more loans can be wrapped by an all-inclusive trust deed (AITD) and their principal balances included in the amount of the AITD note. Thus, a buyer only makes one payment each month, which is paid to the seller. In turn, the seller makes two payments, one on each of the wrapped loans.

Figure 1



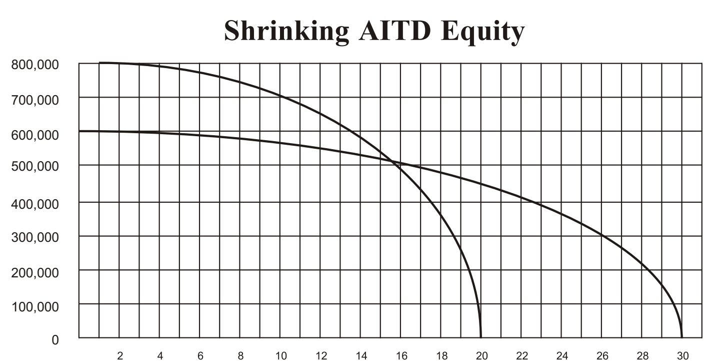
An $800,000 AITD and a $600,000 underlying loan are both amortized over 30 years. The result is an AITD equity which gradually increases as a percentage of the total AITD throughout the term of the AITD.

Figure 2



An $800,000 AITD amortized over 30 years wraps a $600,000 underlying loan amortized over 20 years. The result is AITD equity is increasing. The AITD equity increased from 25% of the AITD by year 18. Thus by year 20, the seller's AITD equity yield is 8%, a decrease from the original 11%.

Figure 3



An $800,000 AITD amortized over 20 years wraps a $600,000 underlying loan amortized over 30 years. Since the AITD equity is shrinking, the seller should demand a payoff of the AITD before year 12, since at this point the AITD and the underlying loan balance would cross over and the AITD would have a negative equity which must be avoided.

The percentage yield on the AITD equity when wrapping two (or more) loans is calculated by dividing the dollar amount of the AITD equity into the seller's *net annual interest income*. The seller's **net annual interest income** is the total of the interest earned on the AITD minus all interest expenses incurred on the wrapped loans.

For example, a seller carries back an AITD which wraps two loans totalling $75,000, a first trust deed loan for $60,000 at 9% interest, and a second loan for $15,000 at 10 ½% interest.

The seller carries a $100,000 AITD at 12%.

The equity in the AITD note is $25,000 ($100,000 AITD minus the $75,000 due on the two wrapped loans).

The net interest income the seller receives is the difference between the $12,000 interest received on the AITD ($100,000 x 12%), and the $6,975 interest expense paid on the underlying first and second trust deed loans ($60,000 x 9% plus $15,000 x 10 1/2%).

Thus, the seller's net annual interest income at the time of the AITD's creation is $5,025.

The effective yield on the seller's equity in the AITD is calculated as the net interest income divided by the dollar amount of the equity in the AITD note.

Thus, the yield on the AITD note is:

$5,025 ÷ $25,000 = 20% effective yield.

The Reverse AITD

The interest rate on an all-inclusive trust deed (AITD) note usually is negotiated at a rate higher than the interest rate on the underlying loan, called an *override rate* or *spread*.

However, sellers occasionally have the incentive to carry back an AITD note with a lower interest rate than the rate on the underlying loan, called a *reverse rate of return* or *negative spread*.

To motivate buyers to pay the price sought by the seller for the property during a depressed seller's market, the seller can offer AITD financing at a **lower-than-market interest rate**.

For example, consider property offered for sale which is encumbered with an $800,000 loan bearing interest at the current market rate of 9%. The loan is payable monthly, amortized over the next 26 years.

To attract buyers to cash out his $200,000 equity in the property, the seller will carryback an $800,000 AITD note at an interest rate of 6%, a sort of **teaser rate** used to attract prospective buyers. The AITD rate, being lower than the rate on the underlying loan, called a *negative spread*, has the opposite effect from an overriding rate. Thus, the seller incurs monthly interest expense in excess of the interest income on the AITD note at the annual rate of 3%.

To accommodate the 3% negative spread, the price for the property is increased by approximately 15% above its current cash market value (five year x 3% reverse spread). The down payment will remain the same. The 15% increase in the purchase price will cover the 3% reverse interest rate charged by the seller until the AITD is due in five years. The AITD note will contain a five year due date so the seller will avoid incurring a *negative equity* in the AITD.

The price paid by a buyer is adjusted upward to offset the seller's *opportunity cost* of financing the sale by extending credit at a lower-than-market interest rate. Financially, what occurs is a one-time "buy down" of the interest rate for the five year life of the AITD note, paid for by the increased price.

Of course, the buyer will pay the exact same amount of dollars for financing and acquisition costs by the end of his first five years of ownership, including payoff amounts, as he would have paid had he assumed the underlying 9% loan and paid a price for the property of $1,000,000 with a $200,000 down payment.

At the end of five years, the final/balloon payment on the AITD will be the same amount as the balance remaining on the wrapped loan.

The entire AITD equity *burns off* gradually, decreasing to zero by the end of the five year period.

Since a default on the final/balloon payment due in five years is foreseeable, the AITD note with a negative interest rate spread must provide for a **default interest rate** of at least the rate on the underlying loan (9% in our example).

Negative amortization

During periods of economic recession when new conventional financing is not available at interest rates which will support past property values and help finance the sale of real estate, a seller seeking to successfully encourage buyers to purchase his property must be willing to either accept a reduced purchase price or carry the financing at a lower-than-market interest rate.

Carryback financing facilitates a sale by supporting the seller's elevated price with a lower interest rate and an accommodating payment schedule which are readily acceptable by buyers.

To attract more creditworthy buyers, the seller can agree to a **graduated payment** schedule over a two or three year period to reduce the carrying costs of ownership and better qualify the property for acquisition by a buyer.

For example, a seller's monthly payment on his existing loan is $6,500. To reduce a perspective buyer's initial costs of ownership, the seller carries back an all- inclusive trust deed (AITD) note calling for the same ($6,500) monthly payment for the first year, sufficient in amount to cover the seller's payments due on the underlying loan.

The payments will rise on the AITD note each year until a payment schedule is reached which will amortize the balance over the desired number of years.

The seller does not need to periodically adjust the rate of interest on the AITD note. However, during the first year(s) of payments, he will be accepting a payment in an amount which will not cover the interest accruing each month, a situation called *negative amortization*.

Here, the accrued and unpaid monthly interest on the AITD note may be added by agreement to the note's principal balance each month. The unpaid interest will then earn interest as principal, called *compound interest*.

The graduated AITD

Instead of a fixed rate of interest coupled with a negative amortization, a seller might offer an all-inclusive trust deed (AITD) with an annually escalating rate of interest and payment schedule to attract buyers.

Being comparable to the 3-2-1 loan buy-down programs used by builders and other informed sellers, the terms of a graduated AITD note for the first three years reduces the present cash value of the AITD note by about 5% of its principal balance, a cost which is passed on to the buyer through a higher-than-market sales price.

Again, the seller carryback financing is facilitating the sale and supporting the price. Without carryback financing, either the value will drop or the property will not sell due to tight mortgage money conditions and uncertainty of buyers about the immediate future at the time of sale.

A seller can agree to a reduced interest rate on the AITD during the first few years after the sale. For example, the AITD interest could start at a low initial (teaser) rate and be adjusted upward periodically, annually or semiannually, by one-half or one percent until a fixed rate for the remainder of the AITD term is reached. Payments would start low and be adjusted upward to maintain the original amortization period, called a *graduated payment note*.

The **graduated AITD** allows property to be sold without the seller lowering the asking price.

For example, a seller wants an interest rate of 9% on carryback AITD financing due in seven years.

For the seller to maintain his sales price and accommodate the buyer, he agrees to a 6% interest rate during the first year after the sale with monthly payments amortized over 30 years.

Further, on each anniversary of the AITD note, the interest rate is increased by 1% until the AITD interest rate is 9%. Thus, the interest rate on the AITD note is:

- 6% in the first year;
- 7% in the second year;
- 8% in the third year; and
- 9% fixed in the fourth year and for the remaining life of the AITD.

The amount of the AITD note payments graduate annually, reamortized over the remaining life of the AITD on each interest rate adjustment. Thus, negative amortization, with its build up of principal, is avoided by all.

Chapter 15 The all-inclusive promissory note and trust deed rider

This chapter explains the preparation and relationship of the all-inclusive note and the two addenda which convert a trust deed to an all-inclusive trust deed (AITD).

Negotiating interest rates and payments

An all-inclusive trust deed (AITD) note, also called a *wraparound note* or *overriding note*, is evidence of an **installment debt** created for a buyer's payment of the balance due on the purchase price of real estate after a down payment. In turn, a seller retains responsibility for, and makes payments on, the existing trust deed note encumbering the property he sold.

The interest rate charged by the seller carrying back an AITD with a five-to ten-year due date is usually comparable to rates available on new first trust deed financing.

Conversely, the interest rate charged on carryback notes with due dates exceeding five to ten years usually exceeds market rates for new loans. However, rates charged by carryback sellers do vary greatly with the needs and expectations of the individuals in each transaction.

Also, sellers rarely seek points or origination fees as compensation for providing the buyer with AITD financing in addition to an interest rate override on the wrapped loan.

Waiver of due-on clause

The all-inclusive trust deed (AITD) carryback seller agreeing to wrap a first trust deed containing a due-on clause must, during negotiations, anticipate the lender's demand to recast its note by increasing the interest rate, payment amounts or due date.

Prior to closing the carryback sale, the seller may want the lender to waive the lender's right to call the loan on the sale and carryback of the AITD, called a *reverse assumption*.

In exchange for the seller agreeing to a modification of the note and the payment of a fee, the seller will obtain the lender's written waiver of the due-on clause. [See **first tuesday** Form 410]

Thus, instead of the buyer assuming the first trust deed note, the carryback seller remains responsible for payment of the note.

Provisions of the all- inclusive promissory note

*Editor's note — **first tuesday** Form 421 is not created for use without major modification when wrapping a variable rate loan. [See **first tuesday** Form 433]*

When the underlying loan is an adjustable rate mortgage (ARM), the seller must make sure the all-inclusive note rate is adjusted concurrent with adjustments in the underlying ARM to avoid a negative cash flow.

The all-inclusive note is used with either the **equity payoff** or **full payoff** varieties of all- inclusive addenda to a regular trust deed.

Preparing the all-inclusive trust deed note

The following instructions are for the use and preparation of an all-inclusive trust deed (AITD) note, **first tuesday** Form 421. Form 421 consists of provisions from a regular interest-included installment note, modified by adding provisions (sections 3.1 and 3.2) to disclose that the amount of the all-inclusive note includes the balance remaining on one or more underlying loans, the payment of which the carryback seller remains responsible. [See Form 421 accompanying this chapter]

Each instruction corresponds to the provision in the form bearing the same number.

*Editor's note — **Check** and **enter** items throughout the agreement in each provision with boxes and blanks, unless the provision is note intended to be included as part of the final agreement, in which case it is left unchecked or blank.*

Document identification:

Enter the dollar amount of the all-inclusive note, the date the note is prepared and the name of the city where the note is prepared. This information is used when referring to this note and must conform with the dollar amount, date and location entered on the trust deed used to secure this note to real estate.

1. *Promise to pay*: **States** the payor's promise to pay the debt on the terms and provisions contained in the note.

1.1 *Payee*: **Enter** the name of the person who is to receive the payments, typically the carryback seller, his assignee or a §1031 buyer's trustee. The all-inclusive trust deed identifies the payee as the *beneficiary*.

1.2 *Place of payment*: **Enter** the city where payments are to be delivered to the payee.

1.3 *Debt amount*: **Enter** the amount of the principal to be paid on the note.

Editor's note — The principal amount is the same as in section 1 above, unless escrow is instructed to enter a different debt amount on closing due to adjustments in price or down payment.

1.4 *Interest accrual date*: **Enter** the date interest begins to accrue, usually the date escrow closes.

Editor's note — The closing date of escrow is usually uncertain until it occurs. Thus, the space for commencement of accrual is left blank when the note is prepared. Escrow is instructed to enter the closing date when it is known.

1.5 *Interest rate:* **Enter** the interest rate negotiated and agreed to in the purchase agreement.

*Editor's note — The all-inclusive note is not formulated for variable interest rates. Use **first tuesday** Form 433 and add all-inclusive provisions noted in instructions for its use.*

2. *Installment payments*: **Enter** the dollar amount to be paid as scheduled installments. If scheduled installments change during the life of the note, also **enter** an asterisk here and at section 5 and, following the asterisk at section 5, **enter** the dollar amount of each change and the date the change will begin.

2.1 *Payment schedule:* **Enter** the day of the month each payment is due to be received by the holder of the note.

Enter the frequency of payments by stating the number of months separating payments, e.g., "consecutive" when installments are due every month, "other" when bi-monthly, "third" when payable quarterly, "sixth" when payable semi-annually and "twelfth" when payable annually.

ALL-INCLUSIVE PROMISSORY NOTE SECURED BY DEED OF TRUST

NOTE: RECOMMENDED FOR USE WITH **first tuesday** FORMS 442 AND 443.

$_______________, dated _____________, 20______, at _____________________________________, California.

1. In installments as herein stated, for value received, I, jointly and severally, promise to pay to

1.1 ____, as the Payee, or order,

1.2 at ____,

1.3 the sum of ____ DOLLARS,

1.4 with interest from __________________, 20______, on unpaid principal

1.5 at the rate of _________% per annum.

2. Principal and interest payable in installments of _____________________________________ DOLLARS, or more,

2.1 on the _____________ day of each __________________ month,

2.2 beginning on the _____________ day of ____________________, 20________,

2.3 and continuing until _____________, 20______, when the principal is due and payable.

2.4 Principal and interest payable in lawful money of the United States.

2.5 Each payment shall be credited first on interest then due and the remainder on principal.

3. The principal amount of this Note includes:

3.1 The present unpaid balance of $_______________, on a debt evidenced by a Note and secured by an existing Trust Deed held by ____, in the original amount of $_______________, which debt remains the obligation of Payee.

3.2 The present unpaid balance of $_______________, on a debt evidenced by a Note and secured by an existing Trust Deed held by ____, in the original amount of $_______________, which debt remains the obligation of Payee.

4. On default in payment of any installment when due, the whole sum of principal and interest may be called immediately due at the option of the Note holder.

5. ____
____
____
____
____
____
____
____
____

6. In any action to enforce this Note, the prevailing party shall receive attorney fees.

7. This Note is secured by a DEED OF TRUST.

Payor's Name: ________________________________
Signature: ____________________________________

Payor's Name: ________________________________
Signature: ____________________________________

Payor's Name: ________________________________
Signature: ____________________________________

Payor's Name: ________________________________
Signature: ____________________________________

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Editor's note — A payment is delinquent after the due date, unless a grace period, by statute or by agreement, extends the date on which payments may be delivered to the holder before becoming delinquent.

2.2 *First payment date*: **Enter** the due date (day and month) for the first payment, typically agreed to as 30 days after the commencement of interest, or the first day of the month first following 30 days after the close of escrow in which case escrow credits the seller with interest which will accrue through the end of the month of closing.

2.3 *Date of final installment*: **Enter** the words "until paid" if the carryback is to be fully amortized by constant monthly payments, or the date when any remaining balance is due. If the due date is on an anniversary of the close of escrow, such as five years after close of escrow, **instruct** escrow to enter this date on closing.

2.4 *Form of payment*: **States** the installment payments and final/balloon payment are to be paid in United States dollars.

2.5 *Interest accrual*: **States** the installment payments are to be credited first toward interest accrued and then to principal.

3. *All-inclusive provisions*: **Provides** that the dollar amount of the existing debt encumbering the property is included in the amount of principal of the all-inclusive note.

3.1 *First underlying encumbrance*: **Enter** the dollar amount of the principal balance remaining on the first trust deed as of the close of escrow, the name of the current lender (beneficiary), and the original dollar amount of the first trust deed. A beneficiary statement should be ordered to disclose this information.

3.2 *Second underlying encumbrance*: **Enter** the dollar amount of the principal balance remaining on the second trust deed as of the close of escrow, the name of the current lender, and the original dollar amount of the second trust deed note. A beneficiary statement is the primary source for disclosure of this information.

4. *Default provision*: **Provides** for the note holder to declare the entire amount of the note due and immediately payable on failure of the payee to timely pay an installment. However, a properly executed call is unenforceable until the reinstatement period during a foreclosure has expired, except in the case of an incurable breach under trust deed provisions for alienation and waste.

5. *Special provisions*: **Enter** any special provisions to be included in the note, such as a late charge or balloon payment notice.

6. *Attorney fees*: **Provides** for the prevailing party in any litigation on the note to recover his attorney fees incurred in the litigation.

7. *Identification of security*: **States** the note is secured by a trust deed. The link up with the property which is the security is made through the trust deed which references this note by amount, date prepared and city of preparation, naming the original payor and payee of this note as the trustor and beneficiary under the trust deed.

Preparation of the all-inclusive trust deed addenda

The two variations of the all-inclusive trust deed (AITD), the **full payoff** and the **equity payoff**, are differentiated by the amount of the payoff demand the carryback seller can request for satisfaction of the all-inclusive note and reconveyance of the AITD. [See Forms 442 and 443 accompanying this chapter]

Each variety is documented by an addendum which is attached to a standard form trust deed, thus converting the trust deed into an AITD.

ALL-INCLUSIVE TRUST DEED ADDENDUM

Equity Payoff

NOTE: Recommended for use with **ft** Forms 421and 450.

DATE:_____________, 20______, at____, California.

Items left blank or unchecked are not applicable.

FACTS:

This is an addendum to the trust deed dated __________________, at ________________________________, California, between ____, as the Trustor, and ____, as the Beneficiary.

AGREEMENT:

1. This trust deed is subordinate to the following notes and trust deeds referred to as Underlying Obligations:

1.1 A trust deed recorded on ______________________________, as Instrument No. ___________________, in ____ County Records, California, executed by ____, as the Trustor, in which ____ is the Beneficiary, securing a note in the original amount of $_______________ with an unpaid balance of $_______________, payable in installments of $_______________ monthly, including _______% interest, ☐ ARM, ☐ plus impounds.

1.2 A trust deed recorded on ________________________________, as Instrument No. _________________, in ____ County Records, California, executed by ____, as the Trustor, in which ____ is the Beneficiary, securing a note in the original amount of $_______________ with an unpaid balance of $_______________, payable in installments of $_______________ monthly, including _______% interest, ☐ ARM, all due _____________, 20______.

1.3 Beneficiary to pay all installments and payments called for on the Underlying Obligations.

2. ☐ Check, if applicable:
Trustor to deposit with Beneficiary sufficient funds for the payment of taxes and fire insurance, specifically one-twelfth ($1/12$) of the annual requirements on each calendar month with installment payment. An advance deposit for such payment in the amount of $_______________ from Trustor has been received by Beneficiary.

3. ☐ Check, if applicable: *[This provision may cause adverse income tax consequences for Beneficiary.]*
Beneficiary shall place the Note on contract collection with a bank, savings and loan, escrow or broker authorized to do so. Such collection shall disburse the monies received first toward the current installment on the Underlying Obligation, then to taxes and insurance if provided for herein, and any amount then remaining shall be disbursed to the holders of the Note.

4. If Beneficiary defaults in his performance under this trust deed, Trustor, provided that he is not then in default, shall have the right, at his option, to cure Beneficiary's default including the Underlying Obligations by either; (a) crediting any and all such payments against the principal and interest payments next becoming due under the Note, or (b) immediately recovering from Beneficiary the amount of such payments including interest thereon at the Note rate.

5. In the event of any monetary default by Trustor, Beneficiary's obligations shall be suspended until the default is cured. If Trustor is delinquent in any payments and Beneficiary consequently incurs penalties or expenses on the Underlying Obligations, the amount of such penalties and expenses shall be added to the Note and be payable by Trustor with the next payment.

6. Any additional principal paid on the Note shall, if Trustor so directs Beneficiary in writing, be paid by Beneficiary to the holders of the Underlying Obligations for credit to the unpaid principal thereof. If the prepayment entitles the holders to receive a prepayment penalty, this amount must then be paid by Trustor to Beneficiary for payment of the penalty. The prepayment penalty shall not reduce the unpaid balance of principal or interest under the Note.

7. In the event of foreclosure of this all-inclusive trust deed, Beneficiary will at the Trustee's sale bid an amount representing the amount then due on the obligations secured hereby less the total balance due on the Underlying Obligations, plus any advances or other disbursements which Beneficiary may be permitted to include.

8. When the Note becomes due and payable or Trustor requests a demand for payoff, the principal amount then unpaid shall be reduced by the then unpaid balance of the Underlying Obligations.

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The two types of AITD addenda contain differing formulas for the amount of the payoff and foreclosure sale demands.

Other than their payoff formulas (sections 7 and 8), the two AITD addenda contain the same information and provisions.

The following instructions are for the use and preparation of AITD addenda to be attached to a regular trust deed. [See **first tuesday** Form 450] When attaching an AITD addendum to a trust deed, state on the face of the trust deed, "The attached AITD addendum is a part of this Deed of Trust."

Each instruction corresponds to the provision in the form bearing the same number.

*Editor's note — **Check** and **enter** items throughout the agreement in each provision with boxes and blanks, unless the provision is not intended to be included as part of the final agreement, in which case it is left unchecked or blank.*

Document identification:

Enter the date and name of the city where the all-inclusive trust deed (AITD) addendum is prepared. This date is used when referring to this document.

Referenced trust deed:

Enter the same date and name of the city as entered on the trust deed to which this addendum is attached. The same date is also entered on the all-inclusive note.

Enter as the trustor the name of each individual or entity signing the trust deed, typically all persons signing the note, except co-signers.

Enter as the beneficiary the payee named in the note, be it the seller of the real estate, his assignee or the §1031 trustee.

1. *Existing financing*: **Provides** information identifying the existing encumbrances on the property, the principal amounts of which are included in the all-inclusive trust deed (AITD) note amount.

1.1 *First trust deed*: **Enter** the date the underlying first trust deed was recorded, its instrument number and the county of record.

Enter the name of the borrower (trustor) and the lender (beneficiary) named in the underlying first trust deed.

Enter the original amount of the underlying first trust deed, the remaining principal balance, the dollar amount of the monthly payment, the interest rate and any due date.

Check the appropriate boxes to indicate a variable interest rate or impounds are provided for in the first trust deed note.

1.2 *Second trust deed*: **Enter** the date the underlying second trust deed was recorded, its instrument number and the county of record.

Enter the name of the borrower (trustor) and the lender (beneficiary) named in the underlying second trust deed.

ALL-INCLUSIVE TRUST DEED ADDENDUM

Full Payoff

NOTE: Recommended for use with **ft** Forms 421 and 450.

DATE:_____________, 20______, at____, California.

Items left blank or unchecked are not applicable.

FACTS:

This is an addendum to the trust deed dated _____________, 20______, at ____________________________, California, between ____, as the Trustor, and ____, as the Beneficiary.

AGREEMENT:

1. This trust deed is subordinate to the following notes and trust deeds referred to as Underlying Obligations:

1.1 A trust deed recorded on ______________________________, as Instrument No. ___________________, in ____ County Records, California, executed by ____, as the Trustor, in which____ is the Beneficiary, securing a note in the original amount of $_______________ with an unpaid balance of $_______________, payable in installments of $_______________ monthly, including _______ % interest, ☐ ARM, ☐ plus impounds.

1.2 A trust deed recorded on ________________________________, as Instrument No. _________________, in ____ County Records, California, executed by ____, as the Trustor, in which ____ is the Beneficiary, securing a note in the original amount of $_______________ with an unpaid balance of $_______________, payable in installments of $_______________ monthly, including _______% interest, ☐ ARM, all due _____________, 20______.

1.3 Beneficiary to pay all installments and payments called for on the Underlying Obligations.

2. ☐ Check, if applicable:
Trustor to deposit with Beneficiary sufficient funds for the payment of taxes and fire insurance, specifically one-twelfth (1/12) of the annual requirements on each calendar month with installment payment. An advance deposit for such payment in the amount of $_______________ from Trustor has been received by Beneficiary.

3. ☐ Check, if applicable: *[This provision may cause adverse income tax consequences for Beneficiary.]*
Beneficiary shall place the Note on contract collection with a bank, savings and loan, escrow or broker authorized to do so. Such collection shall disburse the monies received first toward the current installment on the Underlying Obligations, then to taxes and insurance if provided for herein, and any amount then remaining shall be disbursed to the holders of the Note.

4. If Beneficiary defaults in his performance under this trust deed, Trustor, provided that he is not then in default, shall have the right, at his option, to cure Beneficiary's default including the Underlying Obligations by either; (a) crediting any and all such payments against the principal and interest payments next becoming due under the Note, or (b) immediately recovering from Beneficiary the amount of such payments including interest thereon at the Note rate.

5. In the event of any monetary default by Trustor, Beneficiary's obligations shall be suspended until the default is cured. If Trustor is delinquent in any payments and Beneficiary consequently incurs penalties or expenses on the Underlying Obligations, the amount of such penalties and expenses shall be added to the Note and be payable by Trustor with the next payment.

6. Any additional principal paid on the Note shall, if Trustor so directs Beneficiary in writing, be paid by Beneficiary to the holders of the Underlying Obligations for credit to the unpaid principal thereof. If the prepayment entitles the holders to receive a prepayment penalty, this amount must then be paid by Trustor to Beneficiary for payment of the penalty. The prepayment penalty shall not reduce the unpaid balance of principal or interest under the Note.

7. In the event of foreclosure of this all-inclusive trust deed, Beneficiary will at the Trustee's sale bid an amount representing the amount then due on the obligations secured hereby, plus any advances or other disbursements which Beneficiary may be permitted to include, on which bid Beneficiary to discharge and obtain reconveyance of the Underlying Obligations.

8. When the Note becomes due and payable or Trustor requests a demand for payoff, the principal amount of the payoff shall be the then unpaid principal and interest, and on receipt of payoff funds, Beneficiary to discharge and obtain reconveyance of the Underlying Obligations.

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Enter the original amount of the underlying second trust deed, the remaining principal balance, the dollar amount of the monthly payment, the interest rate and any due date.

Check the appropriate boxes to indicate a variable interest rate or impounds are provided for in the second trust deed note.

1.3 *Payment of wrapped loans*: **States** the seller, as the beneficiary of the trust deed, remains responsible for payment of the underlying wrapped loans referenced in sections 1.1 and 1.2, subject to the terms of the addendum.

2. *Impounds*: **Check** if monthly impounds will be paid to the seller by the buyer for property taxes and casualty insurance.

Editor's note — If a wrapped loan is impounded, then the AITD should also be impounded.

3. *Contract collection*: **Check** if the seller has agreed with the buyer to place the note on collection with a third party.

Editor's note — The seller should not agree to a contract collection provision if he intends to receive the full tax benefits of an installment sale. The collection agent under a mutual agreement with the buyer is deemed to be the agent of the buyer, thus relieving the seller of responsibility for payments on the underlying loan.

4. *Seller's default/buyer's remedies*: **States**, should the seller default on the underlying wrapped encumbrances, the buyer may cure the defaults and make payments directly on the delinquent underlying encumbrance. Payments advanced by the buyer either apply against the agreed-to AITD installments or, alternatively, are refunded by the seller on demand. One is an out-of-pocket setoff, the other is a refund.

5. *Buyer's default/seller's remedies*: **States**, should the buyer fail to make payments on the AITD note, the seller is no longer required to make payments on the underlying wrapped encumbrances unless the AITD is reinstated.

Editor's note — Any late charges or foreclosure costs incurred by the seller on the underlying wrapped encumbrances due to the buyer's default in AITD payments are "passed through" to the defaulting buyer as future advances due the seller if the AITD note does not itself contain a late charge provision.

6. *Prepayment penalty pass-through*: **States** a payoff of an underlying encumbrance caused by the buyer or made at the request of the buyer which incurs a prepayment penalty places responsibility for payment of the penalty on the buyer.

7. Foreclosure bid, equity payoff AITD (Form 442):

States the seller's demand on foreclosure of the all-inclusive trust deed (AITD) will be the amount of his equity in the AITD. The AITD equity is the difference between the balance remaining on the all-inclusive note and the balance(s) remaining on the underlying encumbrance(s). The buyer at the foreclosure sale will take the trustee's deed subject to the underlying encumbrance(s).

7. Foreclosure bid, full payoff AITD (Form 443):
States, on foreclosure under the AITD, the seller will demand and bid the entire balance of the all-inclusive note. Concurrent with the foreclosure sale, the seller will satisfy and obtain a reconveyance of the underlying encumbrance, unless the seller is the successful bidder and credits himself with the underlying loan amount he assumes.

8. Payoff demand, equity payoff AITD (Form 442):

States the payoff demand for reconveyance of the all-inclusive trust deed (AITD) is the difference in the amounts remaining due on the all-inclusive note and the underlying wrapped encumbrances.

8. Payoff demand, full payoff AITD (Form 443):

States the payoff demand for reconveyance of the all- inclusive trust deed (AITD) is the entire principal amount remaining on the all-inclusive note, plus accrued interest, advances and costs. On payoff, the AITD holder will satisfy and obtain reconveyance of the underlying encumbrances.

Chapter 16 Subordination of the trust deed

This chapter reviews subordination agreements and their effect on the enforcement of a purchase agreement and the priority of a trust deed lienholder's security interest in a property.

Altering priorities by agreement

A trust deed lienholder, also called a *beneficiary*, enters into a **subordination agreement**. Under the agreement, he will alter the position of his trust deed lien on title by accepting a position **junior in priority** to another trust deed. The other trust deed may be recorded concurrent with the recording of his trust deed or at a later date.

When the junior lienholder is a carryback seller, subordination means accepting a less secure and more risky position for his trust deed lien than he previously held, thus altering his priority in the chain of title.

For instance, a seller of unencumbered property carries back a second trust deed, junior to a new trust deed loan originated by the buyer to fund the purchase. The seller is now in a more risky position since a loan which was not previously on his title has priority to his carryback trust deed should he have to repossess the property.

The subordination of a trust deed lien can be **voluntary** or **involuntary**, with different consequence for the junior trust deed holder.

A *voluntary subordination* of a trust deed is agreed to in three types of situations:

- **concurrent subordination** — escrow is instructed to record and insure trust deeds in a specified order on title, such as a carryback trust deed will be second in priority to a newly originated trust deed loan [See **first tuesday** Form 401 §2.3 f and h];
- **future subordination** — a carryback seller agrees to subordinate his previously recorded carryback trust deed to a trust deed to be recorded at a later date [See Form 281 accompanying this chapter]; or
- **specific subordination** — a carryback seller actually performs under his prior agreement to reposition his recorded trust deed at a later date by establishing his trust deed as junior and second in priority on title to a specifically described note and trust deed now being recorded.

An *involuntary subordination* of a junior trust deed results from the modification of a senior lienholder's debt, without the junior's consent, which **impairs** the security interest of the junior lienholder.

Listing broker's duty owned to seller

A seller who agrees to subordinate his carryback trust deed to a new loan, either concurrent with the recording of his trust deed or at a later date, is agreeing to accept a lesser position in the property's title as his security than the position he held before the subordination. Thus, subordination exposes a seller to an increased **risk-of-loss** when compared to the title position he originally held.

A *concurrent subordination* agreement arises when a carryback seller enters into a purchase agreement allowing a buyer to record a first trust deed loan on the property, while the seller carries back a second

trust deed to secure a note he receives for a portion of the sales price. [See **first tuesday** Form 150 §§8 and 8.6]

A broker negotiating a carryback transaction as the seller's agent has a duty to inform the carryback seller about the risks of a concurrent or future subordination, and do so before the seller enters into a purchase agreement to sell a property on these conditions. The failure of the seller's broker to advise the carryback seller about the risk of loss subjects the broker to liability for any losses sustained by the seller due to the broker's neglect to inform. [**Timmsen** v. **Forest E. Olson, Inc.** (1970) 6 CA3d 860]

A buyer's broker who negotiates the terms of a subordination agreement with a seller as the exclusive agent of the buyer must be certain the subordination agreement is sufficiently complete in its terms to be enforceable by the buyer. If not, the error subjects the buyer's broker to liability for the losses incurred by the buyer due to the inability to later record a loan.

Terms for subordination

A *future subordination* agreement needed by a buyer in a carryback transaction to meet his expectations for his future use of a property is set out in an attachment to the purchase agreement offer signed by the buyer. If the buyer is to originate a new first trust deed loan in the future and the seller's carryback trust deed is to remain of record, the recorded carryback trust deed will need to be subordinated since it will not be paid in full and reconveyed.

If this offer is accepted by the seller, the subordination agreement attached to the purchase agreement will be used in the escrow process. On the close of escrow, the agreement to subordinate (or its replacement) will be recorded as an attachment to the carryback trust deed.

For a subordination agreement to be enforceable, provisions in the agreement must include:

- the maximum principal amount of the new loan;
- the maximum interest rate;
- the type of interest rate — variable or fixed;
- the repayment schedule;
- the maximum and minimum length of the due date for the final/balloon payment;
- the financing charges to be added to or deducted from the principal; and
- a description of the purpose and use of the loan proceeds. [See Form 281]

Even if the conditions for subordination are complete and adequately clarified in the subordination agreement, it still might not be enforceable. The **final test** of the enforceability of an agreement is the **reasonableness** of the subordination arrangement. A subordination agreement, to be enforceable, may not subject a carryback seller to less than a *fair and reasonable risk* of loss at the time of the subordination. [Calif. Civil Code §3391]

Concurrent vs. future subordination

A buyer agrees to purchase real estate on terms calling for the seller to carry back a portion of the purchase price in a note secured by a trust deed. A provision in the purchase agreement calls for the carryback trust deed to be junior to a new first trust deed loan, both to be recorded on the close of escrow, called a *concurrent subordination agreement*. [See **first tuesday** Form 150 §8]

Escrow is instructed to concurrently record two trust deeds on the close of escrow; the lender's trust deed first, then the seller's carryback trust deed second. Since the trust deed recorded first in time automatically

AGREEMENT TO SUBORDINATE

NOTE: This agreement to subordinate results in your security interest in the property becoming subject to and of lower priority than the lien of some other or later security device.

DATE: ____________, 20_____, at ____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This is an addendum to the following agreement:

☐ Purchase agreement
☐ Escrow instructions
☐ Trust deed
☐ ____

1.1 dated ____________, 20_____, at ____, California,

1.2 entered into by ____, as the Buyer/Trustor, and ____, as the Seller/Beneficiary,

1.3 regarding real estate referred to as ____ ____.

AGREEMENT:

2. Provided Trustor is not in default on the Beneficiary's trust deed, Beneficiary shall, on written request of Trustor, subordinate his trust deed to a new first trust deed loan to be obtained by Trustor prior to ____________, 20_____.

3. The terms of the new first trust deed loan shall include:

3.1 A principal amount not to exceed $______________.

3.2 An annual rate of interest not exceeding _____%.

3.3 Interest to accrue on the remaining balance at a ☐ fixed rate, or ☐ adjustable rate.

3.4 A term not less than _____ years, not more than _____ years.

3.5 Amortization of the loan payable monthly over ______ years, ☐ until paid, or ☐ with a final balloon payment due in not less than _____ years.

3.6 Origination fees and finance charges to be disbursed from the loan proceeds may not exceed _____ points and $______________, respectively.

3.7 Other ____
____

4. ☐ Trustor shall use the net proceeds from this loan to improve the real property, both onsite and offsite. The primary construction to be ____
____
____
____

5. ☐ Trustor shall use the net proceeds from this loan to pay ____________________________________
____
____

6. Trustor shall receive $______________ cash back from the loan proceeds.
These funds to be used for the following purpose(s) ____
____
____

7. ☐ **NOTICE: This subordination agreement contains a provision allowing the person obligated on your real property security device to obtain a loan, a portion of which may be expended on purposes other than improvements on the real property.**

☐ See attached Signature Page Addendum. [**ft** Form 251]	☐ See attached Signature Page Addendum. [**ft** Form 251]
Date: ________________, 20_____	Date: ________________, 20_____
Buyer/Trustor: ______________________________	Seller/Beneficiary: ______________________________
Buyer/Trustor: ______________________________	Seller/Beneficiary: ______________________________

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receives priority, the **concurrent recording** of the seller's carryback trust deed, will make it junior and subordinate to the trust deed held by the lender.

Prior to closing, the seller's interest in the property was not subject to the lender's trust deed loan. On closing the sale, the seller retains an interest in the property subordinate to an encumbrance not previously affecting his interest in title, a change of position exposing the seller to a greater risk of loss.

In contrast, a **future subordination** agreement calls for a carryback seller to subordinate his previously recorded carryback trust deed to a loan to be originated at a later date.

A recorded carryback trust deed containing a future subordination provision is often loosely called a *subordinated first trust deed*. It records first in time, but on the later **specific subordination** of the trust deed as agreed, it becomes second in priority and subject to the terms of a new lender's trust deed.

Purchase-assist or construction loan

The enforceability of a subordination agreement depends on:

- whether the subordination is concurrent or is to occur in the future; and
- the purpose of the trust deed loan to be given priority.

For example, a seller agrees to carry back a note and trust deed and subordinate the trust deed on the close of escrow to new **purchase-assist financing** not to exceed a fixed percentage of the purchase price or a set dollar amount, an arrangement called a *concurrent subordination* agreement. The loan proceeds will be used to fund the purchase price paid to the seller for the property. [See **first tuesday** Form 150 §8]

However, the subordination provision in the purchase agreement does not state the **maximum interest rate** or other financial parameters for installments and the term of the purchase-assist loan. [See **first tuesday** Form 150 §§6 and 8.6]

The seller attempts to cancel the purchase agreement, claiming its subordination provision is unenforceable since it fails to specify the maximum interest rate and installment schedule on the new purchase-assist loan.

Can the buyer enforce a subordination provision in the purchase agreement which does not specify the interest rate and installment parameters for the new purchase-assist loan which is to have priority?

Yes! A carryback trust deed which will be subordinated by agreement to a trust deed securing purchase-assist financing provides the seller with a security interest in the property he sold. None of the loan proceeds are used to improve or add value to the property.

Thus, the agreement to subordinate to a purchase-assist loan without establishing the interest rate or payment parameters is enforceable. The agreement is **just and reasonable** since the seller receives all the net proceeds of the loan, no differently than had he placed the loan on the property himself. Further, no impairment of the seller's second trust deed exists, such as the need to complete construction to provide improvements as additional security, an activity which would result in a significant increase in the risk of loss. [**Ray Thomas Enterprises** v. **Fox** (1982) 128 CA3d 361]

In contrast, an agreement to subordinate a carryback trust deed to a trust deed securing a construction loan requires all essential aspects of the construction loan to be specified in the subordination agreement

since its purpose is to fund the construction of improvements to be added on the secured property.

However, the terms and conditions of a loan to be negotiated and recorded in the future are not known at the time a buyer enters into a purchase agreement. To require specific details concerning the exact amount, precise monthly payments, rate of interest and the absolute due date of the construction loan would be too inflexible to establish a meaningful arrangement for a buyer.

Thus, an agreement to subordinate to a construction loan is enforceable if it includes parameters for the new loan terms and conditions, such as stating the loan amount as a maximum dollar amount, or a percentage of the construction costs (or completed value) of the property.

Additionally, the maximum interest rate and minimum terms for the repayment on the construction loan must be included. Loan amounts, interest rates, repayment terms and use of proceeds for construction have the greatest impact on the carryback seller's risk-of-loss of his security interest established by his recorded trust deed. Thus, the scope of the risk undertaken by the seller must be established. [**Stockwell** v. **Lindeman** (1964) 229 CA2d 750]

Specific subordination to new loan

A *specific subordination* agreement contains the actual terms for payment of a loan secured by a trust deed lien which is to receive priority over a carryback trust deed. Entering into the specific subordination agreement is the seller's performance previously agreed to in the future subordination agreement attached to the carryback trust deed. For a **concurrent subordination** of a carryback trust deed at the close of escrow, a **specific subordination** agreement is not required since the carryback trust deed is actually recorded second in time to the recording of a first trust deed loan. [See **first tuesday** Form 150 §8]

For example, after recording a carryback trust deed, the buyer obtains a commitment for a construction loan. A demand is made on the carryback seller to subordinate his trust deed to the construction loan in compliance with the future subordination agreement attached to the carryback trust deed. To actually subordinate the carryback trust deed, the seller signs a **specific subordination** agreement on a form provided by the title insurance company insuring the priority of the construction loan. The specific subordination agreement is then recorded with the construction trust deed, completing the performance of the seller's prior promise to subordinate his trust deed.

Construction lender's duty

When subordinating a carryback trust deed to a construction loan, a seller's chances for recovery of the unpaid balance of his sales price are no better than a buyer's competency and business acumen, which is to say nothing about the adverse impact of a cyclical local or general economic downturn.

When a seller subordinates a trust deed to a construction loan, he is gambling that the anticipated **increase in value** of the property created by the construction will be realized. Until construction of improvements is complete, the property is over- encumbered; that is, the value of the unimproved property will be less then the amount of the construction loan.

If construction is not completed, a property's value will fail to increase as anticipated. Without a completed structure or improvements, a carryback seller faces the loss of his trust deed interest in the property to foreclosure by the construction lender.

However, once a carryback trust deed has been subordinated, the construction lender has a duty to the carryback seller to properly disburse the construction loan proceeds.

For example, a seller subordinates his trust deed to a construction loan, the net proceeds of which will be used to finance improvements on the property. The construction lender is aware the seller has subordinated his trust deed to the lender's construction loan.

The construction lender controls the disbursement of funds from the construction loan. However, the construction lender allows the buyer to use funds for non-construction purposes.

The misappropriation of loan funds for non-construction uses leaves insufficient funds to continue construction and the project is aborted. Thus, the property value does not increase as anticipated or was necessary to support both the carryback seller's and the construction lender's trust deed interests in the property.

The construction lender forecloses on the real estate and the subordinated trust deed held by the seller is wiped out.

The seller claims the construction lender's misappropriation of loan funds caused his trust deed to become worthless, giving him priority over that portion of the loan funds improperly disbursed.

Does the seller have priority over the construction loan amounts which were misappropriated for non-construction purposes?

Yes! The construction lender voluntarily took **control of the disbursement** of the construction loan, aware the carryback seller subordinated his trust deed to the construction loan in reliance on the lender applying the funds to construction purposes only. Thus, the lender's priority over the seller's specifically subordinated trust deed extends only to the funds properly disbursed to fund construction. [**Middlebrook-Anderson Co.** v. **Southwest Savings and Loan Association** (1971) 18 CA3d 1023]

Involuntary future subordination

Consider a carryback seller who subordinates his trust deed to a trust deed securing a construction loan.

The construction lender, without the consent of the seller, later **modifies the note** by increasing the interest rate and loan amount, and shortening the term of the note.

After the modification, the buyer defaults in payments. The construction lender forecloses, wiping out the seller's junior trust deed interest in the property.

However, the seller claims his trust deed was not eliminated by the foreclosure since his trust deed became senior to the construction lender's trust deed when the lender modified the construction loan and **impaired** his interest in the property without his consent, called an *involuntary subordination*.

Is the carryback seller's trust deed senior to the construction lender's trust deed as a result of the modification and is it thus unaffected by the lender's foreclosure sale?

Yes! A construction lender cannot make material modifications to a construction loan without the carryback seller's consent when the seller's security interest in the property is known to the lender, does not violate provisions in the lender's trust deed and will be adversely affected by the modifications.

Thus, modifications which significantly increase the risk of default and foreclosure cause the first trust deed securing the modified note to **lose priority** on foreclosure and become junior to any lien whose holder — in our example the carryback seller — did not consent to the modification, the result of an involuntary subordination imposed on the carryback second by the modification. [**Gluskin** v. **Atlantic Savings and Loan Association** (1973) 32 CA3d 307]

Recasting the first

Consider a seller who carries back a second trust deed on the sale of property, junior to an existing first trust deed loan previously placed on the property by the seller. A *waiver* of the first trust deed lender's due-on clause and consent to the sale, generally called an *assumption*, are not obtained.

The first trust deed lender learns of the sale and calls the loan under the due-on and acceleration clauses in the trust deed. To avoid the lender's call, the buyer negotiates an assumption of the first trust deed loan with the lender. The note is modified by increasing the interest rate and shortening the due date. The buyer later defaults on the first trust deed loan and the lender forecloses, wiping out the seller's trust deed.

The carryback seller claims his second trust deed now has priority over the trust deed securing the lender's loan since the modification substantially impaired the carryback seller's security by increasing the risk of default and foreclosure.

The lender claims its trust deed retained its priority on the modification since the lender owes no duty to the carryback seller to obtain the seller's consent to a modification.

Does the lender have a duty to the second trust deed holder to obtain his consent prior to the modification?

No! The modification of the note secured by the first trust deed does not result in a change in trust deed priorities since the junior trust deed was created without the lender's consent, in violation of the due-on clause in the lender's trust deed. The lender of record owes no duty to a carryback seller who violates the terms of the lender's due-on provision in its trust deed, to obtain the seller's consent to a modification of the lender's note when the buyer assumes the loan. [**Friery** v. **Sutter Buttes Savings Bank** (1998) 61 CA4th 869]

In a related situation with an entirely different result, a second trust deed is recorded without violating any provisions in the existing first trust deed. Later, the first trust deed holder modifies his note by extending its maturity date and increasing the principal amount. The modification adversely affects the second trust deed holder's security interest by exposing him to a greater risk of loss.

On discovery of the modification, the second trust deed holder claims the first trust deed lost its priority and is now second in priority to his trust deed since he did not consent to the modification which impaired his security.

In this example, the first trust deed did not lose its priority. However, the modifications made to the first trust deed note were entered into after the second trust deed was recorded. Thus, the **modification arrangements** are junior to the second trust deed should a foreclosure occur or a payoff of the trust deed and note be made by the second trust deed holder.

Due to the loss of priority for the modifications, the second trust deed holder retains the same secured position he held in title before the first trust deed was modified. The modification is enforceable against the owner, but not the second trust deed holder. [**Lennar Northeast Partners** v. **Buice** (1996) 49 CA4th 1576]

Waiver of the subordination agreement

A buyer's enforceability of a **concurrent subordination** provision in a purchase agreement and escrow instructions will only, if ever, be in dispute prior to the close of escrow. Subordination will occur on the close of escrow, if at all.

Conversely, neither a buyer nor seller can refuse to close escrow based on the unenforceability of a fully negotiated **future subordination** agreement.

The time for determining the enforceability of an agreement to subordinate a trust deed in the future is when the buyer makes a demand on the seller to sign a **specific subordination** agreement which allows a new loan to be recorded with priority, not before escrow closes. The request to subordinate will take place after the close of escrow when the buyer obtains a construction loan commitment and makes a demand on the seller to actually subordinate his trust deed. [Stockwell, *supra*]

Should a concurrent subordination provision in a purchase agreement allowing for the recording of a trust deed for a purchase-assist loan be unenforceable, flexibility exists for the buyer to waive the provision before the close of escrow should it be challenged by the seller. Here, the buyer's waiver of the subordination provision does not render the entire purchase agreement unenforceable since the buyer does not seek to enforce it.

For example, a carryback seller refuses to close escrow. The buyer makes a demand on the seller to specifically perform on the purchase agreement by closing escrow. The purchase agreement contains a subordination provision calling for the concurrent subordination of the carryback trust deed to a construction loan on the close of escrow.

However, the subordination provision in the purchase agreement fails to establish the parameters of the essential terms of the construction loan. As a result, the seller claims the entire purchase agreement is unenforceable since the subordination provision is **fatally defective**.

The buyer **waives** his right to enforce the subordination provision and seeks to enforce the remaining terms and provisions of the purchase agreement.

Can the buyer waive the defective and unenforceable subordination provision and enforce the remainder of the purchase agreement?

Yes! The buyer can waive the provision in the purchase agreement calling for the concurrent subordination of the seller's carryback trust deed while leaving the reminder of the purchase agreement intact, since the subordination provision was included for the **buyer's benefit** only. Thus, the purchase agreement is enforceable even if its provisions for subordination are not — provided the subordination agreement is unconditionally waived before the buyer makes a demand on the seller to close escrow. [**Reeder** v. **Longo** (1982) 131 CA3d 291]

Chapter 17 Converting nonrecourse paper into recourse paper

This chapter explains how a nonrecourse note held by a lender or carryback seller becomes recourse paper through later arrangements with the owner.

Substituting or eliminating the security

A seller holds a carryback note secured by a third trust deed on real estate he sold, called a *purchase-money* note.

The buyer defaults and on investigating the financial feasibility of foreclosing and repossessing the property, the seller decides to forego foreclosure.

The buyer wants to retain the property, but needs the seller to subordinate his trust deed to a new first trust deed loan which will refinance the combined amounts of the first and second trust deed notes.

The seller offers to reconvey the carryback trust deed in exchange for the buyer executing a new note for the debt owed, but secured by a junior trust deed on real estate other than the property sold. The buyer provides security which the seller accepts.

By mutual agreement between the buyer and the seller:

the seller cancels the purchase money note and reconveys the carryback trust deed; and

the buyer signs and delivers a new note and trust deed in favor of the seller, secured by other real estate owned by the buyer.

Thus, the buyer **substituted security** for the debt owed to the seller. The new note merely evidences the same debt which was represented by the canceled note.

Later, the holder of the first trust deed on the substituted security forecloses, eliminating the seller's trust deed lien from title, called an *exhaustion of the security*.

Since the carryback seller's substituted security interest has been eliminated and the buyer refuses to pay, he sues the buyer to obtain a money judgment for the unpaid amount of the note.

The buyer claims the seller is barred by anti- deficiency rules from collecting on the note since the note evidences a purchase-money debt created between the buyer and the seller to finance the sale of real estate. [Calif. Code of Civil Procedure §580b]

The carryback seller claims anti-deficiency rules do not bar him from obtaining a money judgment on the carryback debt since the debt became secured by real estate other than the property sold.

Can the seller enforce collection of a carryback note which was secured, separately or collaterally, by property other than the property sold?

Yes! The seller can obtain a money judgment to enforce collection on the note even though it evidences a carryback debt. Anti-deficiency rules no longer apply to a carryback debt when the debt becomes secured by real estate other than the real estate sold, called a *substitution of security*. [**Goodyear** v. **Mack** (1984) 159 CA3d 654]

If the seller was barred from obtaining a money judgment to enforce collection of the carryback note, secured by property other than the property sold, the buyer would be improperly allowed to:

- retain the property sold; and
- avoid paying the seller for the property he purchased.

Anti-deficiency and purchase-money paper

To prevent aggravating the fall of real estate values in a recession or depressed economy, buyers of real estate are protected from the additional burden of personal liability on debts classified as *purchase money*.

Two categories of **purchase-money** debts exist, including:

- a note held by a lender and secured by a trust deed on the owner-occupied, one-to-four unit residential real estate acquired by the borrower with the loan proceeds; and
- any note carried back by a seller and secured by a lien only on the real estate purchased from the seller. [CCP §580b]

Should a purchase-money lender or carryback seller judicially foreclose on the secured real estate, the owner is not liable for any deficiency in the value of the real estate to fully satisfy the debt. [CCP §580a]

Waiver of anti-deficiency barred

Consider a lender or carryback seller attempting to collect on a note which was purportedly converted to recourse paper by provisions in a modification agreement between the buyer and the lender.

For example, a carryback seller holds two purchase money notes, each for separate amounts of debt. The sum of both debts equals the unpaid portion owed the seller on the sales price of real estate. The notes are separately secured by first and second trust deeds on the real estate sold, an 80-10-10 financing arrangement. Later, the buyer arranges for a lender to refinance the remaining unpaid balance on the carryback seller's first trust deed note.

However, as a condition of the refinancing, the seller must subordinate his second trust deed to the refinancing so the refinancing will have priority as a first trust deed.

The carryback seller will agree to reconvey his first trust deed and subordinate his second trust deed to the refinancing, if the buyer:

- **personally guarantees** the note he executes; and
- signs a **written waiver** of any anti-deficiency protection.

The buyer agrees. The seller enters into a **specific subordination agreement** allowing his original second trust deed to remain a second, junior in priority to the lender's trust deed. The lender's trust deed and the subordination agreement are recorded on closing the loan escrow.

The buyer then defaults and the first trust deed lender forecloses on the property, wiping out the second trust deed held by the carryback seller. The carryback seller seeks to recover the balance due on the now unsecured carryback note he holds.

The seller claims he is entitled to a money judgment on the purchase money debt since the buyer guaranteed the debt and signed a waiver relinquishing his anti-deficiency protection.

The buyer claims the personal guarantee and the waiver of anti-deficiency protection are unenforceable attempts to circumvent anti-deficiency law on a carryback debt.

Can the carryback seller enforce collection on the note and personal guarantee for the balance due on the note?

No! The buyer is not liable on the note or his guarantee. The seller's carryback debt remained secured by a trust deed on the property sold. Any contract or agreement under which the buyer purports to waive his anti-deficiency protection without a substitution of property as security is unenforceable since it is against public policy. [**Palm** v. **Schilling** (1988) 199 CA3d 63]

Allowing carryback sellers to require a buyer of real estate to personally guarantee a nonrecourse debt would defeat the purposes of anti-deficiency statutes by attempting to impose personal liability on the buyer for what remains a purchase-money debt, a violation of public policy.

Only a third party executing a **guarantee agreement** can be personally liable for amounts due on a purchase-money note. [See **first tuesday** Form 439]

Modifying or replacing the note

Now consider a carryback seller who holds a purchase money trust deed note which is in default.

The seller agrees to extend the due date of the note and lower the interest rate and monthly payments in exchange for the buyer curing the default. The seller believes the modification of the note constitutes a refinancing of the debt, thus converting his purchase-money note into recourse paper.

Here, whether the seller **substantially modifies** the terms of the note, or replaces the original note with a new note, **the debt** evidenced by the note still remains:

- the balance due on the purchase price; and
- secured solely by a trust deed on the property sold.

Thus, the seller is barred from collecting a deficiency.

Consider a carryback seller whose buyer resells the property. The seller accepts an assumption or alters the terms of a purchase money note to facilitate the resale of the real estate.

However, should the resale buyer who executed the assumption, modification or guarantee default, the carryback seller is barred from collecting a deficiency. The note still evidences a purchase- money debt, a carryback debt which remains secured solely by the property sold. Thus, the debt retains its status as a nonrecourse debt for which the **assuming buyer** on the resale is not personally liable. [**Costanzo** v. **Ganguly** (1993) 12 CA4th 1085]

Now consider a seller who carries back a note secured by a second trust deed on the property he sold. Later, the buyer of the property defaults on the note.

The buyer and carryback seller modify the note to include a **provision waiving** the buyer's anti-deficiency rights. Ultimately, the first trust deed holder forecloses on the property, wiping out the seller's trust deed.

The carryback seller seeks to recover a money judgment on the **modified note** since the security has been exhausted.

The buyer claims the seller is barred from recovery on the note since the carryback trust deed note is subject to anti- deficiency law which cannot be waived as long as the note remains secured solely by the property sold.

The seller claims the buyer did waive his anti- deficiency protection since the waiver occurred on a modification of the original note and trust deed.

Can the seller recover a money judgment on the modified note?

No! Recovery from the buyer on the modified carryback note, secured only by the property sold, is barred by anti- deficiency rules. A waiver of anti-deficiency protection is unenforceable since it is against public policy. [**DeBerard Properties, Ltd.** v. **Lim** (1999) 20 C4th 659]

Subordination with an added risk

Construction loans are naturally precarious arrangements due to the risk the improvements may never be completed to create the anticipated property value.

Consider a seller who carries back a trust deed on the sale of property and later **subordinates** the trust deed to a construction loan. Should the construction lender foreclose and wipe out the now subordinated carryback seller's trust deed lien, the seller can collect on the carryback note by obtaining and enforcing a money judgment.

For example, a carryback seller subordinates his trust deed to a trust deed recorded to secure a construction loan. The loan will fund the cost of improvements to be made on the property he sold. Since the carryback trust deed is subordinated to the loan, the risk of loss due to a failure of the development is thrust upon the seller. To cover the added risk of loss presented by the buyer's need to complete the construction, the note's interest rate is increased and prepaid for the period anticipated for construction.

Here, the trust deed note becomes recourse paper due to its subordination to the trust deed securing

Letters of credit

A lender might require a borrower to obtain a letter of credit as a condition for funding a **purchase-assist loan**. Also, a seller agreeing to carry paper might demand a letter of credit as additional security.

The lender or carryback seller can draw on a letter of credit before or after a trustee's sale without violating anti-deficiency statutes or the security first rule. [CCP §580.5(b)]

However, the letter of credit is unenforceable if:

- the note is secured by a purchase money trust deed lien on owner-occupied, one-to-four unit residential property, and
- the letter of credit is issued to a trust deed beneficiary to cover a future default on the obligation. [CCP §580.7(b)]

Thus, a carryback seller or a purchase money lender on an owner-occupied, one-to-four unit residential property is barred from drawing on a letter of credit at any time.

the construction loan. The seller is not expected to assume the risk that the value of the yet-to-be-built improvements may not prove to be adequate security.

Thus, the developer/buyer who promises to construct improvements as **additional security** is not protected by anti-deficiency rules from personal liability should the value of the property prove to be inadequate to satisfy the carryback note. As recourse paper, the seller is allowed to collect his losses from the developer if the property value proves insufficient to satisfy the carryback note. [**Spangler** v. **Memel** (1972) 7 C3d 603]

An **agreement to subordinate** a carryback trust deed to a future construction loan does not itself cause the trust deed note to lose its nonrecourse character. However, the note becomes recourse paper when the carryback trust deed is actually subordinated to a construction loan. [See Form 281 in chapter 16]

Conversely, the actual subordination of a carryback trust deed to the buyer's purchase-assist trust deed loan, or a later refinancing of the senior trust deed loan, does not present a change in the use or nature of the property, nor provide additional security, which would convert a nonrecourse note to recourse paper. The physical property remains the same, contrary to the seller's security interest in the property since the seller's loan-to-value ratio (LTV) has been altered by accepting a secured position which overencumbers the property. [**Shepherd** v. **Robinson** (1981) 128 CA3d 615]

When a carryback seller agrees to subordinate his carryback trust deed to purchase-assist financing secured only by the property sold, the subordination does not alter the character of the property sold (no construction promised) nor the nonrecourse nature of the seller's (undersecured) purchase-money note. [**Lucky Investments, Inc.** v. **Adams** (1960) 183 CA2d 462]

A seller who carries back a trust deed, secured only by a subordinated interest in the property sold, is charged with knowing the value of the real estate sold and thus the value of the position accepted as security.

For example, should a lack of value exist, or a market-induced reduction in the value of the property sold occur due to overpricing or a recession, the buyer is not personally liable on a seller carryback note secured by the property sold, even if the debt is later subordinated to new financing. [**Brown** v. **Jensen** (1953) 41 C2d 193]

Reconveyance of the trust deed

A lender or carryback seller holding a note secured by a trust deed cannot **unilaterally waive and reconvey** the note's security, then proceed against the borrower or buyer as though the now unsecured note was converted to recourse paper by the *release of the security*.

A release of the security must be **mutually agreed** to between the lender and borrower for the secured debt to become a recourse debt.

For example, a carryback seller holds a note for the balance due on the purchase price of real estate. The note is secured by a second trust deed on the property sold.

The property value has decreased below the amount owed on the note, due to a destabilized real estate market, and the buyer defaults.

The carryback seller agrees with the buyer to modify the terms of the note and release the security, for fear of having his trust deed wiped out should the first trust deed holder foreclose.

As agreed, the carryback seller reconveys the trust deed and the carryback note becomes unsecured. [See **first tuesday** Form 472]

The Modification of the Promissory Note, executed by the buyer in favor of the seller, is attached to the note as an *allonge* and states the changes in its terms and the release of the trust deed lien by reconveyance. [See **first tuesday** Form 425]

Later, the buyer defaults on the now unsecured note held by the carryback seller, who in turn sues the buyer for a money judgment to recover the balance due on the note.

The buyer claims anti-deficiency rules bar the carryback seller from collecting on the note since the seller's note was a purchase money obligation, created to finance the sale of the property.

However, the anti-deficiency rules no longer apply to the carryback note. The buyer and seller mutually agreed to a reconveyance of the trust deed to release the security.

The carryback seller can pursue the buyer to collect the balance due on the note since the security was released by mutual agreement.

To bar a seller from collecting on an unsecured carryback note — a note which is unsecured by mutual agreement between the seller and the buyer — would not advance the purposes of anti- deficiency rules. The buyer would be able to keep the property and pay less than the agreed-to price.

In contrast, a carryback trust deed note which becomes unsecured by mutual agreement is legally distinct from a carryback note which was **unsecured from the outset** of the sales transaction, even though both are recourse notes.

A seller who carries back an unsecured note on the close of a sales transaction has a *vendor's lien right* which he can impose on the property sold and judicially foreclose (if it is still owned by the buyer). The note was at all times unsecured and represents the amount of the purchase price remaining unpaid, contrary to the note held by the previously secured carryback seller.

In addition, a carryback seller or lender who requires a buyer to execute two notes for the **same debt**, one note secured by the real estate purchased, the other purportedly unsecured, is barred from collecting a deficiency. The underlying debt, evidenced in its entirety by each of the two notes, is secured by the property sold. Thus, the debt is a nonrecourse debt which can only be collected from the value of the property sold. [**Freedland** v. **Greco** (1955) 45 C2d 462]

Additional security for recourse

Now consider a lender who holds a purchase-money note. The debt is a purchase-assist loan secured by a first trust deed on owner- occupied, one-to-four unit residential property. Local real estate values have become depressed, causing the real estate to no longer be adequate security for the note.

The owner defaults on the note. To cure the default, the lender and owner mutually agree that:

- the terms of the note will be modified; and
- the owner will additionally secure the note by executing a trust deed to create a lien on another property owned by the owner.

Later, the owner defaults again. The lender judicially forecloses on both the owner's personal residence and the additional security, yet a deficiency in value still exists leaving the note unsatisfied.

Can the lender obtain a money judgment to collect the deficiency after judicially foreclosing on both the buyer's residence and the additional security?

Yes! Anti-deficiency rules do not bar the lender from a money judgment when a purchase-money note becomes **additionally secured** by other property. The note no longer is non-recourse, purchase-money paper. [CCP §580b]

However, a lender or carryback seller seeking a money judgment on recourse paper must concurrently foreclose on all of the secured properties in one judicial foreclosure action. No *piecemeal foreclosure sales* are allowed under a judicial foreclosure when multiple properties are the security and a deficiency judgment is sought. [CCP §726(a)]

Chapter 18 — No downpayment carryback sales

This chapter reviews a seller's financing of a sale with little to no cash down payment.

Minimizing carryback risks

A couple decides to purchase income producing property to begin a real estate investment program.

Each spouse has a significant personal income, with a combined discretionary disposable income in excess of $75,000 annually which they have decided to commit to real estate investments.

Over the years, the couple spent most of their disposable income on the costs of high living. Consequently, they have accumulated insufficient cash savings for a meaningful down payment on a purchase.

Despite their lack of savings, the couple's high income enables them to make a *deferred down payment* through significant additional monthly or quarterly principal payments after they acquire a property. Thus, the couple is willing to subject themselves to a self-enforcing savings program by building up equity through debt reduction.

As a **deferred downpayment investment program**, the couple will build up an equity in the property they purchased by making quarterly payments of additional principal. The quarterly principal reductions will be in addition to the regular monthly payments. For the seller, the extra principal payments are treated as a deferred cash down payment.

The additional principal payments will be made during the first few years following the purchase of the property. With the couple's $75,000 excess annual income, they have the capacity to pay a seller an additional $225,000 in principal over a three- year period.

At their agent's suggestion, the couple signs a purchase agreement offer on an income producing property which is financially suitable for the couple, on the terms:

- the purchase price will be $1,000,000;
- no cash down payment will be made;
- the buyer will pay all closing costs;
- a seller carryback note and trust deed will be executed for the entire amount of the purchase price;
- the current market interest rate will be applied;
- monthly payments will be based on a 30-year amortization;
- twelve (12) quarterly payments of principal will be made totalling $225,000 over three years; and
- a 10-year due date will provide for a final/balloon payment.

Attached to the offer is the carryback disclosure statement prepared by the buyer's agent. [See **first tuesday** Form 300]

The buyer's agent delivers the offer to the listing agent. Together, they review the offer for presentation to the seller.

Editor's note — Had the property been encumbered by an existing trust deed note, the carryback could be structured as a regular second trust deed note or an all-inclusive trust deed note (AITD).

Risk review by the listing broker

Before submitting an offer to the seller, the listing agent concludes the offer is unsuitable for his client as it stands.

Must the agent hand the no-down offer to the seller?

Yes! A listing agent, acting as the agent of his brokers, is duty bound to present all legitimate offers he receives, even though he may consider the offers to be unsound or otherwise unacceptable to the client.

The listing agent, on submitting the offer to the seller, points out the carryback aspects of the offer which present additional legal and financial risks to the seller, including:

- the seller will not be cashed out since the net proceeds of the sale will be in the form of a note — thus, the seller should receive either a higher-than-market interest rate or a higher-than-market price for his property to compensate for the risk of loss he would avoid on an all-cash sale [**Timmsen** v. **Forest E. Olson, Inc.** (1970) 6 CA3d 860];
- the carryback note is *purchase money* paper — a nonrecourse debt — so if the buyer defaults, the seller's only remedy is to foreclose on the property since a money judgment is not allowed on a nonrecourse note [Calif. Code of Civil Procedure §580b]; and
- without a down payment, cash proceeds from the sale will not exist to absorb the out-of-pocket costs to foreclose should the couple default on the carryback note.

For the property to support the financial burdens imposed on the carryback seller by a foreclosure, an equity of no less than 10% to 15% must exist above the seller's carryback trust deed note. Without a cash down payment large enough to generate net cash proceeds to the seller on closing, the buyer has not established an equity in the property at the time of closing.

To demonstrate the financial risk facing the seller should he ever have to recover the property on a buyer's default, the listing agent prepares a **Carryback Foreclosure Cost Sheet** and reviews it with the seller. On the cost sheet, the agent estimates the costs the seller will incur during a foreclosure and later resale of the property. The seller can use the disclosure to estimate the cash reserves he will need if he has to foreclose on the property. [See Chapter 20]

Also, the listing agent prepares a carryback disclosure statement on a form designed to comply with mandatory disclosures on one-to-four unit residential properties, which this income producing property is not. [See **first tuesday** Form 300]

Disclosures when presenting the offer

When presenting an offer, a listing agent owes an agency duty to the seller to disclose all aspects of the proposed transaction which are known to the agent and might affect the seller's decision to accept the offer, such as:

- the **legal aspects** of carrying paper since the seller takes on the rights and obligations of a mortgage lender [Calif. Civil Code §2956];
- the **tax aspects** of the profit and income reportable in an installment sale [Internal Revenue Code §453; see Chapter 13]; and
- the **financial suitability** for the seller of the risks of loss involved in carrying paper. [Timmsen, *supra*]

Instead of accepting the offer or returning the offer as rejected, the listing agent suggests a counteroffer to re-structure the transaction so it will be financially suitable for the seller.

Motivated sellers: price, interest, taxes

One hundred percent carryback financing on a little to no downpayment transaction has benefits for a seller. A seller may be motivated to accept a no-down offer by his desire to:

- increase his ability to sell the property at the price sought;
- receive a flow of interest income; and
- defer profit tax reporting on the sale until the principal is paid.

The seller who is able to provide carryback financing can sell his property more readily. Buyers often do not have, or want, to use all their cash funds for a downpayment. Also, buyers are typically more interested in acquiring the property if the seller provides the purchase money financing needed to buy the property since the two parties can handle all the financial aspects of the sale without the hassle of arranging new financing with an institutional lender.

The seller contemplating a no downpayment transaction faces tax considerations, including:

- he will receive no down payment and thus no profit will be reported in the year of sale except from principal on monthly payments;
- no debt relief will occur and thus no profit tax will be due in the year of the sale — the seller will wrap any underlying debt with an all-inclusive trust deed (AITD) note if the amount of his existing loan exceeds his remaining cost basis; and
- no profit will be reported in the carryback note until principal is paid or the note is sold or assigned as collateral.

No downpayment, default and beyond

In a little to no downpayment carryback sale, the major legal and financial risk the carryback seller faces is a default by the buyer on the carryback note. A default will force the seller to consider initiating foreclosure.

The sum of the combined amounts of the carryback note, underlying financing, the costs of foreclosure and resale are supported solely by the value of the property.

Thus, when sufficient downpayment funds have not been received, the seller commencing a foreclosure will have to use his own funds to pay the costs of foreclosure if he is to protect the value of his security interest in the property. Unless the **property value** rises, funds expended by the seller after a little to no down payment sale will not be recovered on a foreclosure and resale of the property.

No matter the amount of the down payment, the carryback seller must promptly start foreclosure proceedings on a default. The value of any equity securing the carryback note diminishes daily due to the accrual of property taxes, interest on underlying trust deed notes and property insurance premiums. Also, an actual decrease in the marketability, and thus the value of the property, occurs due to deferred maintenance and upkeep which often accompanies a default.

Even if the carryback seller immediately initiates foreclosure on a default, completing a typical problem-free second trust deed **foreclosure and resale** of the property can easily consume cash funds equal to 15% of the property's value, paid approximately 50:50 from the seller's cash reserves and cash proceeds from a resale.

Again, any cash loss on the carryback can only be recovered from the property's resale price.

On a 100% carryback sale, unless the property value increases by a minimum of 15% between the date

of the original sale and the date of the resale after foreclosure, a loss of principal and foreclosure costs will most likely occur.

Minimizing the seller's risk of loss

All sales involve some degree of risk of loss, as do all loans and carryback notes. A seller should not avoid a sale or a carryback note simply because a potential risk of loss exists.

The correct approach is for the seller and his agent to analyze the extent of the risk and take steps to **offset** and **cover the risk** by:

- eliminating the degree of risk by requiring a **larger down payment** sufficient in amount to cover the cost of foreclosure and resale;
- receiving a **premium** in the form of an increased price, a higher interest rate or greater principal reductions; or
- acquiring **additional security**, guarantees, letters of credit, etc.

The seller does not need to rely solely on the real estate sold to secure his carryback note in a no-down transaction. Through a counteroffer, the seller can negotiate with the buyer to deliver up additional security which is acceptable to the seller. The additional security can be real estate or personal property owned by the buyer or others.

Additionally, a carryback note becomes recourse paper when it is secured by property other than the property sold, or in addition to the property sold. With recourse paper, the seller may pursue a deficiency judgment against the buyer by completing a judicial foreclosure if the fair market value of the properties securing the carryback note becomes less than the amount of the underlying loans and carryback note.

Through a counteroffer, the carryback seller negotiates to include provisions such as:

- a **continuing guarantee** for the carryback note (guarantors are not protected by anti-deficiency laws, only the buyer) [See **first tuesday** Form 439];
- a **security interest** in personal property or other real estate, called *cross-collateralization* [See **first tuesday** Form 436]; and
- the **carryback of an unsecured note** for part of the price (5% to 10% of the price). [See **first tuesday** Form 424]

The seller can negotiate to **cross-collateralize** the carryback note by securing it by both the property purchased and other property owned by the buyer (or other persons). Cross- collateralization by the buyer secures the carryback note by using **one trust deed** to determine multiple parcels of real estate as security for payment of the carryback note, called a *blanket trust deed*.

By carrying a **blanket trust deed**, the seller is able to obtain a money judgment against the buyer if the market value at the time of a judicial foreclosure sale does not cover the balance due on the cross-collateralized carryback note. [CCP §§580a, 580b]

The brokerage fee in a no-down deal

Payment of the brokerage fee is an additional concern for brokers and sellers involved in minimal or no down payment transactions.

The problem is not the amount of the fee, but how and when the broker will collect the fee he has negotiated in a cashless transaction, such as a no-down sale or an exchange of equities.

In cash sales, the fee is paid in cash by the seller on the close of escrow. When the sale or exchange includes little to no cash down payment and no new financing to generate cash funds, the broker, like the seller, must wait to be paid.

Typically, the broker's fee will be paid by the seller out of the first payments made by the buyer on the carryback note. Alternatively, the buyer can create a separate note to pay the broker's fee (reducing the amount of the seller's carryback note by an equal amount), payable to the broker and secured by a junior trust deed. The purchase price for the real estate remains the same.

However, the broker must understand that a note signed by the buyer and secured by one-to-four unit residential property, purchased and occupied by the buyer, is **nonrecourse paper**. The note finances part of the purchase of the buyer's residence. [CCP §580b]

Thus, if the buyer defaults and an underlying trust deed holder (i.e., the seller) forecloses on the property, the broker's trust deed is wiped out, leaving the note unsecured. Here, the broker cannot obtain a personal money judgment against the buyer/occupant of the one-to-four unit residential property. The broker simply loses his fee.

*Editor's note — This anti-deficiency rule only applies if the buyer purchases and occupies a one-to-four unit residential property. If the buyer does not occupy the property, or it is not one-to-four residential units, the broker can recover a money judgment for his unpaid services evidenced by the note previously secured by a wiped-out trust deed. [**Kistler** v. **Vasi** (1969) 71 C2d 261]*

The broker fee and nonrecourse paper

To avoid being wiped out by the foreclosure of a senior trust deed, a broker may wish to avoid holding nonrecourse paper. Several options are available, for example:

- a seller can **guarantee** a buyer's junior trust deed note making the seller personally liable to the broker if a foreclosure wipes out the broker's security;
- the buyer or seller can provide property other than the real estate being sold as **additional security**;
- the broker can become a co-owner/beneficiary of a pro rata share of the carryback note or an assignee of the note for payment of his fees;
- the broker can carry an unsecured recourse note, payable by the seller or by the buyer, as part of the price paid for the property; or
- the brokerage fee can be a recourse note signed by the seller and secured by a *collateral assignment* of the seller's carryback trust deed note. A security agreement would provide for all or part of the carryback payments to be received by the broker until the brokerage fee is paid in full. When the fee is fully paid, the broker will reassign the trust deed to the seller.

However, the seller takes on an additional risk of loss under any arrangement in which he agrees to pay the deferred fee. The risk arises when the **buyer defaults** on payments and the carryback seller is required to foreclose on the property.

If the broker owns a percentage of the carryback, the carryback seller and the broker become partners in any foreclosure process. To avoid anarchy, they should enter into a co-ownership agreement as the beneficiaries of the trust deed before the closing of the sales escrow. Otherwise, on a foreclosure, they

will have to find a way to cooperate without the benefit of a previously written agreement.

If the broker holds a note for the fee signed by the seller, collateralized or not by the seller's carryback note, the note for the fee is recourse/deficiency paper. The seller can be forced to pay — even when the carryback sale sours and the seller is faced with a loss — unless the note held by the broker provides for relief in the event the buyer defaults on the carryback note.

Chapter 19 The downpayment note

This chapter discusses a buyer's use of his equity in a property he presently owns to secure a note, given in lieu of a cash down payment on the purchase of a property, when the balance of the price paid is another note secured by the property purchased.

Buying property by creating paper

A cash-poor real estate investor, during a recessionary period of weakened real estate prices and tightened credit, perceives the scarcity of willing buyers as his opportunity to purchase additional real estate.

The investor presently owns a rental property valued at $400,000, encumbered by a first trust deed with a $200,000 balance. [See Figure 1]

However, the investor does not currently, and will not in the foreseeable future, want to **sell or exchange** the real estate he owns since it is a consistent income producer. His long-term investment goal is to buy properties and keep those which produce a consistent net operating income (NOI) and are located in relatively recession-proof areas that are likely to appreciate in the future.

As a result, the investor's offers to buy property will not be made **contingent on the sale** of the property he currently owns in an effort to generate cash for a down payment — even though his cash reserves are inadequate to purchase property.

Likewise, the investor will not consider raising down payment funds by borrowing against the equity in his currently owned property due to lost time and expenses incurred with new financing for:

- loan origination costs (points, fees, title);
- the nonnegotiability of interest rates, often tied to volatile cost-of-funds indexes; and
- the lengthy and uncertain qualification process.

Further, the investor is not interested in acquiring a new loan to buy the property. Instead, he will assume, or take title subject to, an existing loan if the interest rate and assumption fees to do so are favorable.

To increase his holdings, the investor will place his existing equity at risk by putting it up as security to buy the new property on credit. The factual matrix of his offer to buy property will include encumbering the property he owns with a trust deed to secure a note he will execute as a **down payment** on the purchase of another property, often called *the creation of wealth formula*, or *papering out the seller*.

Papering out the seller

With insufficient funds for a 15% to 20% cash down payment, the investor will make offers to acquire property on terms calling for him to execute an installment note for the amount of the 15% to 20% down payment, given in lieu of a cash down payment. The installment note will be secured by a trust deed on the equity in the property the investor presently owns.

For example, a broker employed by the investor under an exclusive right-to-buy retainer agreement, called a *buyer's agent*, locates a suitable property worth $600,000, encumbered by a $400,000 first trust deed. [See Figure 1]

Figure 1

Debt and Equity

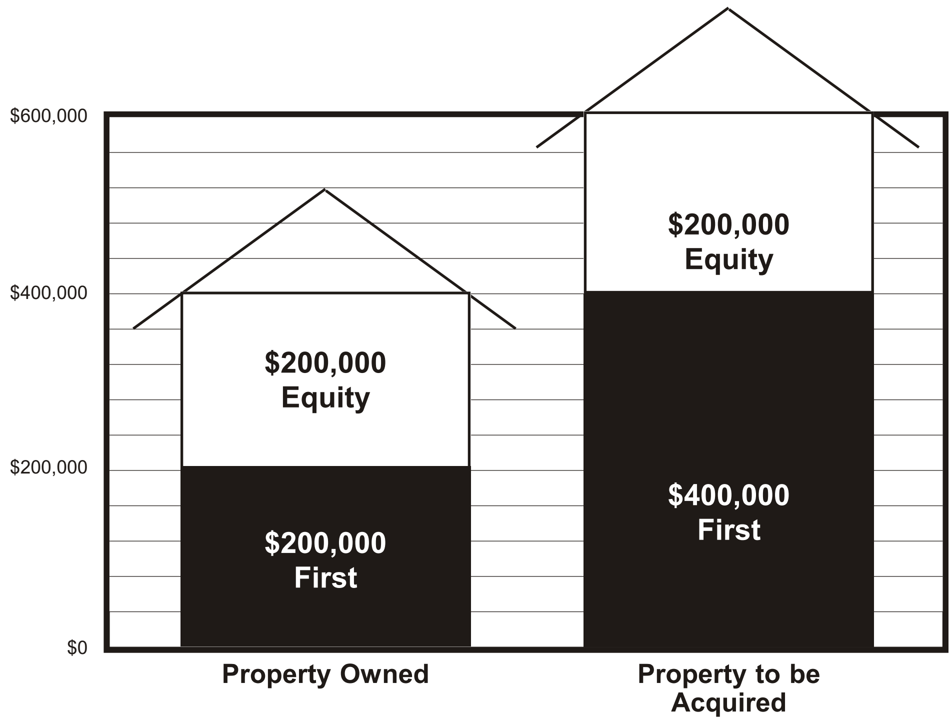
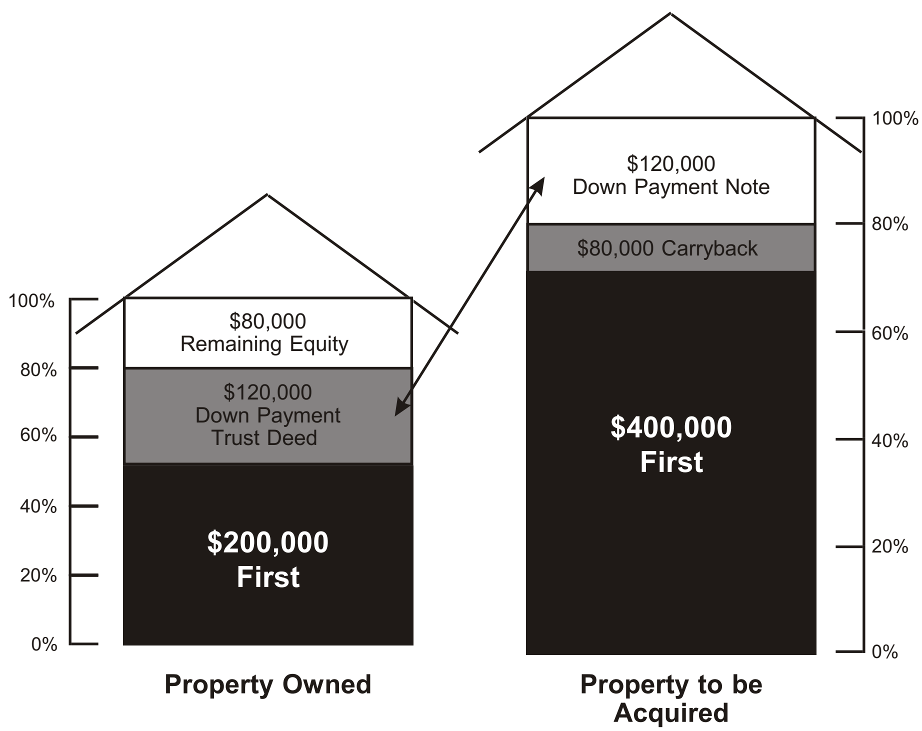


Figure 2

Papering out the Seller



The seller wants to liquidate his investment in the property with the goal of converting its equity into management-free interest bearing assets.

The investor's broker views the seller's aspirations as a prime match to satisfy the investor's real estate acquisition objectives.

Both the original property owned by the investor and the seller's property have adequate equity to support additional financing for up to 80% of their value. Thus, both properties could be properly used as security to generate enough cash to pay the entire purchase price of the seller's property.

An offer is prepared by the investor's broker calling for the investor to acquire the seller's real estate by creating **two notes** in favor of the seller:

1. a $120,000 **downpayment note** to be secured by a second trust deed on the property presently owned by the investor; and

2. an $80,000 **carryback note** to be secured by a second trust deed on the property to be purchased by the investor.

The investor is to assume the existing loan on the seller's property. [See Figure 2]

Thus, the further encumbering of both properties with second trust deeds will leave each with a 20%-of-value equity cushion, a sufficient loan-to-value (LTV) ratio to allow full recovery on the notes should the seller need to foreclose on either trust deed (and the property values do not decline).

By using the equity in each property (and assuming the existing loan on the property being acquired), the investor finances 100% of the purchase price, except for the cash needed to pay the closing costs and brokerage fees which he can control through negotiations.

Overlapping goals

For the seller, this 100% financing arrangement meets his investment goals. Selling the property on a downpayment note and a carryback note converts the seller's real estate equity into:

- interest income with a high degree of safety (secured by a trust deed with an 80% loan-to-value (LTV) ratio);
- higher interest rates on the carryback notes than offered on savings accounts; and
- a fair degree of liquidity should he suddenly need to sell or collateralize the notes for cash.

Instead of a $120,000 down payment in cash, the investor executes an installment note for $120,000 in favor of the seller, a sort of *deferred down payment*. The use of a downpayment note secured by a redeemable equity in real estate is a viable substitute for an immediate cash down payment.

The balance of the seller's equity remaining after deducting the $120,000 down payment is $80,000. A carryback note will be executed by the investor in favor of the seller for the $80,000 amount.

Consequently, the transaction will require:

- two notes, each for separate portions of the total $200,000 equity in the seller's property;
- two trust deeds, each securing one note, each recorded as a lien on the separate properties; and
- two title insurance policies, one for each property insuring the priority of the trust deed which encumbers it.

Motivated sellers

Sellers who are in their retirement years, or at least trying to retire from their property, should consider being "papered out" (using 100% carryback financing) for many reasons, including:

- the **deferral of profit taxes** on an installment sale until the principal is paid [Internal Revenue Code §453; see Chapter 22];
- the downpayment note and the purchase-money note are each secured by separate trust deeds encumbering different parcels of real estate, each with **loan-to-value (LTV) ratios** which provide solid equity cushions;
- the notes convert the seller's income flow from *management-intense* rental income, which may have long lost its depreciation shelter, to relatively *management-free* interest (portfolio) income; and
- the downpayment note is **recourse paper** on which a deficiency is collectible from the buyer since the note is secured by property other than the property being purchased. [Calif. Code of Civil Procedure §580(b)]

Taxwise, a seller taking a profit on the sale of property (price minus cost basis equals profit) will eventually pay approximately 25% to 30% in combined state and federal taxes on the entire profit.

Many carryback notes secured by second trust deeds on depreciable property are comprised entirely of profit, due largely to depreciation schedules, refinancing and increased property value resulting from inflation and appreciation. On a cash-out sale, a seller ends up retaining around 70% of his net proceeds, the balance being lost to the Internal Revenue Service (IRS) and the Franchise Tax Board (FTB) as profit tax due for the year of sale. Thus, no interest will be earned by the seller on the taxes he paid to be cashed out.

However, profit taken on a sale which is allocated to an installment note is not taxed when it is received. The profit allocated to the principal amounts of the downpayment note and carryback note remain untaxed. The profit allocated to the principal will **bear interest** until the principal is paid. [See Chapter 22]

As principal on the note is paid (or the note is **hypothecated**), the profit allocated to the principal is taxed. Until payoff, a seller collects interest on the 30% of his profit he will ultimately pay in taxes — the *earning power* of the unpaid profit tax is retained by the seller.

Thus, the typical seller in a carryback installment sale is earning a yield 50% to 100% greater than the after-tax yield on a taxable cash transaction.

To prevent a premature loss of monies due to the payment of taxes on an early payoff, a seller should consider negotiating the inclusion of a **prepayment penalty** equal in amount to the profit tax he will pay when a portion or all of the note is prepaid.

Additionally, an all-inclusive trust deed (AITD) with the proper collection provisions, carried back and secured by the property sold, will defer even greater amounts of profit tax when the property sold has an existing encumbrance of any amount. [See Chapter 13]

Only existing owners may try this

Besides locating a motivated seller, a buyer must already own a property with an equity adequate to secure a downpayment note given to purchase the seller's property.

The downpayment note technique only works for buyers who already own real estate with equities which

could be financed. Due to this fact, first time buyers cannot use the downpayment note technique since they own no real estate and thus have no equity to offer as security for the downpayment note. In some instances, a relative (i.e., a parent) might provide the security needed to get first time buyers started in real estate ownership, especially if they decide to purchase during the period between three to four years following a peak in real estate sales prices, not withstanding an interim shock to the economy during the recessionary period such as occurred on 9/11/01.

Properties with qualifying equity

Real estate presently **owned** by a buyer and the real estate he will **acquire** must each possess sufficient amounts of equity to support the note it will secure if the property is to provide adequate security in the event of a default and foreclosure sale.

Thus, the property owned and the property to be acquired must each have existing equities well in excess of 20% of the property's total value. The further encumbrances placed on the respective properties, in the form of a downpayment note and a carryback note, must be calculated to leave each property encumbered with a loan- to-value (LTV) ratio no greater than 80%. [See Figure 2]

In our previous example, the real estate owned by the investor has a 50%-of-value first trust deed. Thus, the real estate he owns has 30% of its value available to provide adequate security (up to an LTV of 80%) for a downpayment note created to buy the seller's property.

The real estate the investor wants to acquire is encumbered by a first trust deed with a 67% LTV ratio ($400,000 debt/$600,000 value). Thus, the seller's real estate has $80,000 of equity available to secure an equal dollar amount of carryback financing and be encumbered for no more than an 80% LTV ratio.

With an 80% LTV ratio, the seller has adequate security in the property he sold to provide a cushion sufficient to provide for a full recovery on the carryback note from the present value of the real estate should he foreclose on the property. The costs of foreclosure and resale of a property by a second trust deed holder usually represent around 20% of its resale value. [See **first tuesday** Form 303]

Paper in the real estate market

Buyers purchase real estate by giving a seller U.S. dollar-denominated assets, such as:

- cash;
- notes, existing or to be created;
- an exchange of an equity in real estate or personal property; or
- a percentage participation in the ownership of a limited liability company (LLC), partnership, corporation or real estate investment trust (REIT).

The actual assets a buyer may use to buy real estate and the form of consideration acceptable to sellers depend on the economic condition of the real estate market and the seller's objectives at the time of the transaction.

In times of easy, low-interest money accompanied by a reciprocal rise in real estate prices, a seller is more likely to demand all cash since an abundance of cheap money is available to creditworthy buyers.

Conversely, when institutional lenders and federal monetary policy combine to reduce the supply of money necessary to finance a continuing high-volume of real estate sales transactions, the alternative for buyers and sellers is to **create** the needed supply of credit (carryback financing). The financial alternative

Figure 3 *Excerpted from **first tuesday** Form 154*

4. A note, to be executed by Buyer in favor of Seller, in the amount of . . . . $_______________ as a down payment through escrow, payable $_______________ monthly, or more, beginning one month after closing, including interest at ______% per annum from closing, due _____________, 20______.

4.1 This note is to be secured by a ___________________ trust deed on real estate referred to as ____
____.

4.2 This trust deed to be junior to current taxes, CC&Rs and the following encumbrances:

First encumbrance:	**Second encumbrance:**
Amount . . . . $_______________	Amount . . . . $_______________
Monthly payment. $_______________	Monthly payment. $_______________
Interest rate . . . . . ______%	Interest rate . . . . . ______%
Due date ______________________	Due date ______________________
Lender ________________________	Lender ________________________

4.3 This note and trust deed to contain provisions to be provided by Seller for: ☐ due-on-sale, ☐ prepayment penalty, ☐ late charges, ☐ __________________

4.4 This note and trust deed are subject to the purchase money anti-deficiency provisions of California Code of Civil Procedure §580b.

4.5 ☐ Buyer to provide a Request for Notice of Default and Notice of Delinquency to senior encumbrancers. [See **ft** Form 412]

4.6 Buyer to hand Seller a completed credit application on acceptance. [See **ft** Form 302]

4.7 Within ______ days of receipt of Buyer's credit application, Seller may terminate the agreement based on a reasonable disapproval of Buyer's creditworthiness. [See **ft** Form 183]

4.8 This trust deed to be insured by a Lender's ☐ CLTA, or ☐ ALTA, form policy of title insurance paid for by Buyer. If Buyer is unable to deliver this insured trust deed, or if the improvements on the secured real estate are destroyed or materially damaged prior to closing, then Seller may terminate this agreement and demand all instruments and funds be returned to the parties depositing them, and Buyer is to pay all reasonable escrow costs and charges.

to borrowing cash to fund a purchase, or an exchange of properties, is a credit sale, evidenced by notes executed by the buyer and secured by real estate.

In a credit sale, the buyer also **creates wealth** for himself. The buyer is able to purchase real estate during a vicious cycle in the market which has become nonresponsive for financially depleted sellers. An enterprising buyer looks forward to a future with an improving economic environment; a seller views the market retrospectively as producing continuously declining prices.

Additionally, the use of carryback paper eliminates all the problems associated with institutional financing, except for the assumption of the existing loan.

For example, in times of tight money, the use of a downpayment note may be the only way for a seller to close a sale, since interest rates or prices (or both) are too high to allow real estate to be readily sold at any price.

A downpayment note permits the buyer to qualify for financing, not just based on his personal income, but rather on his credit history as a debtor and the solid value in two parcels of real estate.

Structuring the paper

A downpayment note transaction is structured in sets of two: two notes, two trust deeds and two title insurance policies.

A buyer's first step toward making an offer to buy property begins with a purchase agreement drafted for the downpayment note transaction. It contains an additional provision for the downpayment note in lieu of a cash down payment. [See Figure 3]

A good-faith cash deposit, or cash through escrow, in an amount at least equal to the seller's closing costs and brokerage fees should be considered. Logically, the downpayment note is separate from the cash the seller may need for closing costs.

The terms of the **downpayment note** and trust deed set forth in the purchase agreement include:

- the amount of interest and principal payments;
- the due date for the final/balloon payment; identification of the property securing the note;
- the terms of existing financing on the property securing the note; and
- any provisions for a late charge, prepayment penalty and due- on-sale interference. [See Figure 3]

All other terms contained in a regular purchase agreement for income property are included in the purchase agreement in addition to the downpayment note provision.

Ironically, the longer the period before the **due date** for the final/balloon payment, the more lucrative the transaction is for both a long-term investor and a tax-minded seller. The buyer, being an investor, wants the greatest period of time to payoff or arrange financing to payoff the notes. The seller wants to retain the benefits of the deferred tax liability on installment sales reporting for as long as feasible, a motivation parallel in time to the buyer's.

For the seller, the downpayment note is *recourse paper* since it is secured by property other than the property sold. [CCP §580b]

The buyer can remove the **recourse nature** of the downpayment note by the inclusion of an anti-deficiency provision agreed to in the purchase agreement, called an *exculpatory clause*. [See Figure 3; See **first tuesday** Form 154 §4.4]

The regular carryback note

After a downpayment note, the buyer executes a carryback note to be secured by the property sold. The dollar amount of this note represents the balance of the purchase price remaining after subtracting the principal amounts of the downpayment note and the existing loan the buyer assumes from the purchase price.

Carryback paper secured only by the property sold is *nonrecourse paper*. It is seller- extended credit which assists the buyer to finance the purchase of the real estate that is the security for repayment. [CCP §580b]

Unlike the elimination of the recourse nature of the downpayment note by inclusion of an **exculpatory clause**, the **nonrecourse nature** of the carryback note cannot be eliminated by agreement, called *waiver*.

Title insurance on two parcels

Two policies of title insurance will be required to insure the downpayment note transaction.

One policy will jointly insure both the grant deed and the carryback trust deed on the property sold, called a *California Land Title Association (CLTA) Joint-Protection (JP)* policy.

The second policy will insure the trust deed on the property owned by the buyer, a lender's policy of title insurance most likely similar to a CLTA policy since the seller will have inspected the property.

Swing loan aspect for a cash sale

Conceptually for sellers, a downpayment note can be used as a *swing loan* to complete the sale of real estate when downpayment funds are not yet available to his buyer.

When the cash down payment to be made by the buyer is not forthcoming and the seller is willing to wait several months or a year to receive the cash, a downpayment note can be negotiated as a temporary substitute for the buyer's cash down payment so the sale can be closed.

For example, a buyer and seller enter into a purchase agreement contingent on the **sale of other property** the buyer owns.

On the date the buyer is to close his purchase, the sale-of-other- property contingency has not been removed. He has not yet closed a sale on his other property. Without the cash net proceeds from the sale of his property, the buyer cannot acquire the seller's property, as agreed in the purchase agreement.

The seller's broker suggests the seller accept a downpayment note executed by the buyer and secured by the buyer's unsold property. If agreeable to the seller, the buyer will be able to close the sale using this temporary **swing loan financing** in lieu of cash.

In this scenario, the equity in the buyer's other property not yet sold must be confirmed by the broker as sufficient to justify accepting it as security for the delayed cash down payment to be evidenced by the note. The swing loan note could also be *cross-collateralized*, securing it by a trust deed describing both parcels as encumbered by the (blanket) trust deed lien.

If the buyer's property does not sell, the buyer will need to negotiate an extension of the note, refinance or further encumber the properties to generate cash to meet the seller's payoff demand and avoid foreclosure.

A word of caution: creating a further encumbrance on property, other than one-to-four residential units, junior to an existing trust deed containing a **due-on clause**, triggers the lender's right to call or recast the existing trust deed note. Before recording a second trust deed on a property which is not a one-to-four unit residential property, it is prudent to obtain a **waiver** by the lender holding the first trust deed containing the due-on clause. [See Chapter 12]

Chapter 20 Carryback foreclosure and resale costs

This chapter discusses the risks of financial loss by a seller on a carryback sale, and the safeguards needed to cover those risks.

Seller protection led by disclosures

An absentee owner is unable to effectively manage a small income-producing property he owns. Confronted with below market rents, unreliable tenants and deferred maintenance, he decides to sell the property. The condition of the property and its income will continue to deteriorate until it is sold to a local buyer who can provide hands-on management.

The owner contacts an agent for the purpose of marketing the property and locating a suitable buyer. The property has an existing fixed-rate, long-term loan which can be assumed by a qualified buyer. The owner and listing agent believe their asking price for the property is not set too high.

To pursue his asking price and pass on the cost of disrepair and the delinquent rent situation to the buyer, the seller lists the property with the agent's broker to market the property for sale and locate a buyer. The listing terms include a low down payment and a **carryback note** and trust deed. The seller and his listing agent agree an acceptable offer must include a *further-approval contingency* calling for the owner to confirm the buyer is financially and personally qualified to purchase the property, and is prepared to cure the deferred maintenance and upgrade the tenancies on the property.

However, the listing agent quickly determines the owner is not familiar with real estate financing techniques and does not fully understand the **risk-of-loss** involved in carrying back a second trust deed note. The risks, if known and understood, might cause a (prudent) seller to take steps to cover the risks and protect his continuing investment represented by the carryback note. The listing agent knows he is **duty bound to inform** the owner of the risks of carrying back a second trust deed note, so appropriate decisions can be made regarding the terms for payment of the sale price and management of the carryback note and trust deed.

Covering the risks of junior financing

The risks of carrying paper are similar to the risks taken by an equity lender holding a comparable junior lien on the title to a property. The risks of a junior lender, and thus a carryback seller, are covered or compensated by employing several techniques and variables, including:

1. The amount of the **down payment** which sets the size of both the equity the buyer feels compelled to protect and the amount of cash sales proceeds the seller will net to cover the risk of future advances he may have to make should the buyer default;

2. **Further collateral** in addition to the seller's equity in the property sold, be it personal property or other real estate, a situation sometimes called *cross collateralization* which converts the carryback note to *recourse paper* and avoids anti-deficiency laws;

3. A **personal guarantee** from someone other than the buyer, which may be secured by real estate owned by the *guarantor*, to assure the seller the carryback note will be paid off by the guarantor on the buyer's default on the note (in essence, the guarantor agrees to buy the note on a default and the

seller agrees to assign it to the guarantor who will then deal with the default foreclosure proceedings);

4. A **premium interest rate** on the note to cover the risks created by a small down payment which is inadequate to provide the seller with sufficient cash sales proceeds to pay all the carrying costs and trustee charges on a foreclosure and resale of the property should the buyer default (the interest rate for this minimal down payment situation would be comparable to sub-prime mortgage rates and junk bonds which are generally 3% to 6% above prime mortgage rates);

5. **Monthly payments** based on a short amortization schedule to quickly reduce the principal balance remaining on the note and increase the seller's cash reserves before a default (which usually does not occur for three to five years);

6. **Private mortgage insurance** (PMI), available from insurance companies if the buyer qualifies, to cover any loss of principal and interest due to a default by the buyer;

7. **Assignment of rents** as additional security (in the form of cash) if the property sold is income property which generates rents. Rents can be readily collected by the use of pre-printed notices sent to both the buyer and the tenants which informs them to pay the carryback seller or be personally liable to the carryback seller for nonpayment;

8. A **credit application** and a **net worth statement** (balance sheet) from the buyer which the seller uses to order out a credit report to confirm the buyer's propensity to timely pay his debts and by a review of the buyer's networth to confirm he has assets with sufficient equity to bolster the buyer's ability to pay the carryback note (and possibly provide additional security for the carryback note); and

9. **Inspect and investigate** the care and management of real estate already owned by the buyer to determine if he maintains and operates property without deferring maintenance.

The foreseeability of a default

Lender rights and obligations are especially prevalent when a **buyer defaults**, a foreseeable occurrence against which the trust deed lien is the first line of defense.

When the buyer defaults on a trust deed, the carryback seller may proceed with a foreclosure and recover the value of the property if the delinquent amounts are not paid in full. Defaults on a trust deed include the buyer's failure to:

- pay installments on the carryback note;
- pay property taxes, assessments and hazard insurance premiums;
- pay senior lenders; or
- maintain the property.

During the foreclosure period, the carryback seller may need to use cash reserves to keep the senior trust deed note current and avoid the initiation of foreclosure proceedings by a senior lender. Commencement of foreclosure by the senior lender will add to the carryback seller's costs of recovering the property.

Most importantly, the seller's source of recovery on a carryback note which is secured only by the property sold is limited to the value of his *security interest* held under the second trust deed lien. The dollar value of a junior trust deed holder's secured position on the property's title is the property's fair market value, minus:

- the balance remaining due on the senior loan;
- the dollar amount of foreclosure;
- resale costs; and
- carrying costs (taxes, insurance, operating expenses) until the property is resold.

Any rents collected from tenants by the seller due to the seller's enforcement of his assignment of rents lien (in the trust deed) will be applied to offset the costs of "carrying" the property and deducted from the amounts due the seller to set the amount of an underbid at a trustee's sale. Also, interest on the carryback will be unpaid and uncollected unless paid on a bid by a cash buyer at the trustee's sale, or recovered in the resale price should the seller recover the property at the trustee's sale and resell it.

For the seller to limit his risks of lost equity and interest on non-income producing property, the cash proceeds from the buyer's down payment on the initial sale of the property must equal or exceed the total of eight to twelve months of senior trust deed payments, other carrying costs incurred during this period, and foreclosure and resale costs. If the buyer's down payment is large enough, the value of the seller's security interest in the property should be sufficient to recoup the principal balance and interest on the carryback note, the property's carrying costs and the costs to foreclose and resell the property.

The listing agent representing the broker must prepare and review a *Foreclosure Cost Sheet* with the carryback seller to impress upon him the need for an adequate down payment (or additional security or a guarantee). The information in the disclosure will aid everyone in an analysis of the risks a second trust deed holder is exposed to and the steps to be taken to cover those risks. [See Form 303 accompanying this chapter]

The **Foreclosure Cost Sheet** is useful as a visual aid to make disclosures. The worksheet documents the potential expenditures, and the cash reserves required to cover the risk of default and protect the carryback paper from loss.

Foreclosure cost calculations are made by the agent and reviewed with the seller on each of two occasions:

- once when accepting the listing; and
- a second time when presenting an offer.

Lastly, a major hidden cost of foreclosure is the **time and energy** spent by the carryback seller to keep track of any foreclosure and resale process he may have to undertake. The recovery of this opportunity cost is built into the increased sales price for the property, the increased interest yield and the increased monthly payment amount on the carryback note.

The foreclosure risk of having to sell the property again is often shared by the brokers and agents through various deferred fee arrangements to reduce any moral hazards present in the agent's optimistic encouragement of a carryback sale.

A preforeclosure workout

When the amount of an underlying senior loan is more than 75% of the property's current market value and a buyer defaults on the seller's carryback note, the seller should first negotiate with the buyer for a *deed-in-lieu of foreclosure* and possession to the property before initiating foreclosure. Negotiations for a **deed-in-lien of foreclosure** should be considered at the time of the default, but must be considered before commencing foreclosure.

A deed-in-lieu is a grant deed containing special language to assure title insurers the debt has been

canceled, and no lease-option or other lender/debtor relationships has been created to cause the deed-in-lieu to be recharacterized as a *mortgage-in-fact*.

A deed-in-lieu, as a preforeclosure workout, eliminates many of the risks of foreclosing. The deed-in-lieu saves the carryback seller the high cost of foreclosure, while possibly providing the buyer with some "walking money", consideration for immediately conveying title and transferring possession to the seller under the deed-in-lieu.

Additionally, the deed-in-lieu **must be insured** by a title company before the seller accepts it. Without title insurance on the deed-in-lieu to confirm the condition of the title, liens may have attached to the property or a change in vesting may have occurred which renders the deed unacceptable.

Cash reserves for foreclosure

If a deed-in-lieu remedy or other pre-foreclosure workout (short payoff sale or modification of the note) is not available to resolve a default, a trustee's foreclosure sale is the next most expedient procedure for recovery on a defaulted note.

However, the carrying costs and trustee's charges incurred during a trustee's foreclosure may reduce some or all of the financial benefits of a carryback note if the down payment is inadequate (less than 15% to 20% of the price), the value of the property has not risen or the seller procrastinates in commencing foreclosure.

For example, suppose a buyer pays $100,000 down and assumes $800,000 in existing loans on a $1,000,000 sales price. The seller carries back the $100,000 balance remaining to be paid on the purchase price in a note and trust deed secured by the property sold.

The brokerage fees and other costs, credits and adjustments associated with the sale amount to $50,000. Thus, the seller's net proceeds on the sale are $50,000 cash and the $100,000 in paper. [See **first tuesday** Form 310]

However, foreclosure and resale costs can run from 15% to 20% of the property's resale value, in this case, $150,000 or more. More than half of this amount would be met from the seller's cash reserves to pay foreclosure and other carrying costs until the property is resold. Foreclosure on income producing property can be less demanding on a seller's cash reserves since the carrying costs may be offset by rent received under the trust deed's assignment of rents provision.

The carryback seller is also subject to the risk the buyer may file a **bankruptcy petition** to preserve any equity he may have in the property. The carryback seller's foreclosure sale is automatically halted by filing the petition, called a *stay*, and remains in effect until the bankruptcy court releases the stay.

Further, a buyer who realizes he will lose the property often fails to continue to properly maintain the property, called *impairment of the security* or *waste*. If only deferred maintenance occurs, the carryback lender will incur the expense for **fixing up** the property to resell it (or to keep it and rent it).

These conditions are common risks any mortgage lender is exposed to. As with all mortgage risks, the risks are manageable and capable of being covered by a mix of a sufficient down payment, a premium interest rate, assignment of rents on income property, a short amortization period, additional security and guarantees. A real estate market of rising values is always a cure for a failure to adequately cover the risks of loss.

FORECLOSURE COST SHEET

Costs and Net Proceeds on Foreclosure and Resale

NOTE: This cost sheet is prepared and presented to carryback sellers and lenders secured by a junior trust deed.

These disclosures help junior trust deed holders anticipate the funding necessary to foreclose and the net proceeds of a foreclosure and resale.

The figures estimated in this cost sheet will vary with time and thus are not a guarantee.

This form does not consider the effects of a bankruptcy, eviction, lost interest, or assignment of rents provision.

1. This estimate of costs incurred to foreclose and resell property under a trust deed is prepared for the following:

☐ Purchase Agreement ☐ Loan Agreement ☐ Exchange Agreement

☐ Trust Deed and Note ☐ Option

1.1 dated ______________, 20______, at ____, California,

1.2 entered into by ____,

1.3 regarding property referred to as ____.

2. Estimated resale value of the real estate . . . . $_______________

3. Balances on senior trust deeds at time of resale

3.1 Underlying first . . . . $_______________

3.2 Underlying second . . . . $_______________

4. Cash advances from the time of default through closing of a resale

4.1 Taxes . . . . $_______________

4.2 Insurance . . . . $_______________

4.3 Improvement bond assessments . . . . $_______________

4.4 Common interest development assessments (condos) . . . . $_______________

4.5 Payments on underlying trust deeds (number of months ______). . . . . $_______________

5. Foreclosure costs and fees to recover a property

5.1 Trustee's guarantee policy . . . . $_______________

5.2 Recording notices . . . . $_______________

5.3 Publishing notices . . . . $_______________

5.4 Postage . . . . $_______________

5.5 Trustee's fees . . . . $_______________

5.6 Miscellaneous charges. . . . . $_______________

6. Resale costs after foreclosure and recovery of the property

6.1 Repairs and fixer-up costs . . . . $_______________

6.2 Title insurance premiums . . . . $_______________

6.3 Escrow fees and charges. . . . . $_______________

6.4 Broker fees and charges . . . . $_______________

7. Estimated loans, advances, costs and charges to foreclose and resell (3, 4, 5 and 6): . . . . (-)$_______________

8. Estimated net proceeds available to pay off carryback trust deed . . . . $_______________

I have diligently prepared this estimate.

Date: ___________, 20___________

Seller's Broker: _________________________________

By: ____

I have read and received a copy of this estimate.

Date: ___________, 20___________

Seller's Name: _________________________________

Seller's Signature: ______________________________

Seller's Signature: ______________________________

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Eviction by the involuntary landlord

A buyer wiped out by a foreclosure sale must vacate and deliver possession of the property to the carryback seller who acquires it at a foreclosure sale. If the buyer does not vacate, the seller must serve the buyer with a written *Three-Day Notice to Quit Due to Foreclosure*. [Calif. Code of Civil Procedure §1161a(b); see **first tuesday** Form 578]

However, a wiped-out buyer might refuse to vacate the property on expiration of the three-day notice. If this occurs, the carryback seller will need to proceed with an *unlawful detainer* (UD) action, as would any landlord dealing with any tenant who unlawfully detains the property.

At the **unlawful detainer** hearing, the carryback seller must show the property was acquired at a trustee's sale and all statutory notice requirements for the sale and the UD action have been satisfied to evict the buyer.

After foreclosure and recovery of possession, the carryback seller who reacquires the property is back to square one — he owns the property again, minus his out-of-pocket expenses to foreclose.

Other security devices

Land sales contracts, reverse trust deeds, unexecuted purchase agreements with occupancy (lease-purchase sale) and lease-option sales, are sales which typically present the additional risk and cost of a **judicial foreclosure** should the buyer default and challenge an eviction action.

The completion of a foreclosure of the lien created by any security device is a requisite to recovering possession, since the buyer's *right of redemption* (to pay off the debt) must be eliminated to clear title of the buyer's ownership interests. These alternative security devices do not usually contain a *power-of-sale* clause to authorize the more efficient, less expensive trustee's foreclosure sale.

The exposure to the repossession risk of a judicial foreclosure outweighs any purported benefit these alternative security devices might offer in a small- downpayment carryback sale.

Judicial foreclosure, regardless of the security device used, is a lengthy, emotionally troublesome and costly procedure. A trust deed foreclosure by a trustee's sale is the maximum risk for recovering title any seller should accept when extending credit to help finance the sale of real estate.

Analyzing the Foreclosure Cost Sheet

The **Foreclosure Cost Sheet**, **first tuesday** Form 303, is used by a broker or his agent to inform a carryback seller or lender about the estimated cost to foreclose on the secured property and resell the property in the event the buyer or borrower defaults on the trust deed. As a disclosure, the seller or lender is informed of the out-of-pocket expenditures needed to foreclosure and resell the property, and of the net proceeds resulting from a foreclosure and resale, all foreseeable events

Preparing the carryback foreclosure cost sheet

The following instructions are for the preparation and use of Form 303, the **Foreclosure Cost Sheet**. Form 303 is designed for a broker or his agent as a disclosure of the cost of a foreclosure of the trust deed and resale of the secured property, for the purpose of anticipating the cash reserve requirements of a foreclosure and resale, as well as the projected net proceeds recoverable by the combined events.

The numbers on the worksheet correspond to the numbers given provisions in the form.

*Editor's note — **Check** and **enter** items throughout the worksheet in the boxes and blanks for each provision, unless the provision is not intended to be included as part of the worksheet, in which case it is left unchecked or blank.*

1. *Referenced document*: **Check** the appropriate box to indicate the document for which the form is prepared as a disclosure.

1.1 *Date of document:* **Enter** the date and location which identifies the referenced document.

1.2 *Parties to the document:* **Enter** the names of the principal parties to the referenced document.

1.3 *Real estate involved:* **Enter** the common address or other identification of the real estate which is the subject of the referenced document.

2. *Resale value*: **Enter** the property's present value. If the seller has to foreclose within the first few years, the foreclosure will likely be due to a lack of sufficient value in the property he sold. Thus, the present value might be an overstatement.

3. *Senior loans*:

3.1 *Underlying first trust deed*: **Enter** the dollar amount of the principal balance remaining on any existing first trust deed loan.

3.2 *Underlying second trust deed*: **Enter** the dollar amount of the principal balance remaining on any existing second trust deed loans.

4. *Future cash advances*: **Provides** for the future advances the carryback seller or junior trust deed lender will make until the foreclosure is completed and the property is resold to keep current those obligations which have priority to the junior trust deed lien, or would otherwise impair the junior trust deed holder's interest in the property if not paid.

Editor's note — The agent estimates delinquencies and carrying costs for several months of payments up to the trustee's sale and thereafter for several months until a resale escrow can be closed, a total of 8 to 12 months without considering the receipt of rental income if the property is occupied by the buyer.

4.1 *Property taxes*: **Enter** the dollar amount of property taxes to be paid (two installments).

4.2 *Insurance premiums:* **Enter** the dollar amount of the hazard insurance premiums (one year policy).

4.3 *Improvement bond assessments:* **Enter** the dollar amount of delinquent and future payments of any improvement/bond assessments (Mello-Roos).

4.4 *Home owner's association (HOA) assessments*: **Enter** the dollar amount to be paid for any ownership association charges which are senior to the carryback or will be enforceable against the junior trust deed holder after he completes the foreclosure and becomes the owner of the property.

4.5 *Loan installment:* **Enter** the total dollar amount and number of monthly installments on the underlying senior encumbrance(s), for the period from default to resale and disposition of the property.

5. *Foreclosure costs*: **Provides** for the expenses the junior trust deed holder will advance on a default to commence foreclosure and pay for all the expenses for notices, fees and conveyancing.

Editor's note — To obtain the foreclosure cost, the agent calls a foreclosure service and requests estimates of charges for all items typically incurred on foreclosure of the second trust deed.

5.1 *Trustee's guarantee policy:* **Enter** the dollar amount of the charge for a trustee's title guarantee policy. The charge is based on the unpaid principal on the second trust deed note.

5.2 *Recording notices*: **Enter** the dollar amount of the recording costs of foreclosure notices and the trustee's deed.

5.3 *Publishing notices:* **Enter** the dollar amount of the charge estimated for publishing the trustee's sale notice for three weeks. The estimate is based on the length of the legal description of the property, and the advertising rate at the newspaper.

5.4 *Postage:* **Enter** the dollar amount estimated for the cost of postage for mailing the notices to interested parties.

5.5 *Trustee's fees*: **Enter** the dollar amount of the trustee's fees based on the unpaid principal of the junior trust deed note.

5.6 *Miscellaneous charges*: **Enter** the dollar amount of any miscellaneous charges.

6. *Resale costs*: **Enter** the dollar amount of the expenditures it is estimated the seller will incur to market the property and close a sale.

*Editor's note — The broker estimates the price for interior painting and replacement of flooring and window coverings. The title insurance premium and escrow costs for a resale will be the same as for the carryback sale, and can be taken from the carryback seller's net sheet. [See **first tuesday** Form 310]*

6.1 *Repairs and fixer-up costs:* **Enter** the dollar amount of the fixer-up costs anticipated to be incurred before the property can be properly marketed.

6.2 *Title insurance premiums:* **Enter** the dollar amount of the title insurance premiums on resale, based on the property's estimated resale value.

6.3 *Escrow and charges:* **Enter** the dollar amount of the escrow fees/charges for resale.

6.4 *Broker fees:* **Enter** the dollar amount of the brokerage fee the seller will incur on resale.

7. *Total expenditures*: **Enter** the total dollar amount of all loans, charges and carrying costs borne by the junior noteholder to foreclose and resell the property from lines 3 thorough 6.4.

8. *Amount recovered*: **Enter** the dollar amount of the seller's **net proceeds** by deducting all charges and cost in §7 from the estimated resale price in §2.

Additional costs:

Other important **financial aspects** of foreclosure/resale which may be discussed with the carryback client for a full understanding of his trust deed benefits and risks include:

a. any offsetting **rental income** collected from tenants under the trust deed's assignment of rents provision [See **first tuesday** Forms 456, 457, 458];

b. eviction costs to remove **holdover owners** or tenants after the trustee's foreclosure sale is complete;

c. delays in foreclosure or eviction due to the filing of a **bankruptcy petition** by the buyer, plus any attorney fees incurred by the seller due to bankruptcy proceedings;

d. expectancy of a **change** in the property's value due to local housing demand for the property over the next three years;

e. income tax reporting triggered on completion of the foreclosure for any portion of the down payment (and principal payments on the carryback note) which have not been reported as profit on the carryback sale;

f. alternatives to foreclosure, such as a **deed-in-lieu** (after default), renegotiating the terms of the carryback note, or a pre-foreclosure workout or sale (short sale) of the property in cooperation with the buyer.

Chapter 21 Minimum interest reported on a carryback note

This chapter analyzes a seller's annual tax reporting of income from a carryback note at no less than a minimum interest rate.

Charge or impute a note's AFR

A seller of real estate extends credit to a buyer for a portion of the property's sales price, evidenced by a note carried back on the sale, called an *installment sale* or *carryback sale*.

In addition to stating the principal amount owed, the note sets forth the interest rate charged by the seller, the monthly payments of principal and interest, and the due date for the final balloon payment.

Taxwise, the **interest income** portion of each payment is reported by the seller as *portfolio category* income. The interest income is then offset by any losses in the operation or sale of portfolio assets, such as land holdings, ground leases, income property subject to management-free, triple- net leases, loans or stocks and bonds. Any remaining interest earnings are reported and, unless offset by losses from the business or rental income categories and personal deductions, taxed at ordinary income rates, ranging from a floor of 10% to a ceiling of 35% (in 2008).

The **principal amount** of the carryback note represents an allocation of part of the **basis** and an allocation of a portion of the **profit** taken on the sale, when the owner's remaining cost basis in the property is a greater amount than the loan encumbering the property. [See Chapter 22]

The cost basis portion of each payment of principal is a *return of capital*, which is not taxed. On the other hand, the profit portion of the principal is comprised of *gains* to be reported within the **property's income category** (trade/business, rental/passive, portfolio or personal residence) and is taxed, if not offset, by other losses.

The **profits** on the sale of income property are typically composed of *unrecaptured depreciation gains* and *long-term capital gains*. These gains, respectively, will be taxed at a ceiling rate of 25% for unrecaptured depreciation gains and 15% for long-term capital gains, unless offset by:

- capital or operating losses on other properties within the same income category;
- allowable losses from other income categories; or
- itemized deductions.

The dynamics of planning

The 133% spread that exists between the long-term capital gain tax (15%) and the maximum tax on interest (35%) is the dynamic which makes tax planning interesting to brokers, attorneys and accountants.

Sellers can reduce the overall amount of their taxes on an installment sale, while still receiving the same total amount of dollars over the life of the installment sale, by:

- increasing the purchase price of the property sold (thus increasing profits which are taxed at a 15% rate); and
- decreasing the interest rate charged on a carryback note (thus reducing ordinary income which is taxed at higher rates than gains).

To combat this shift in earnings from interest to profits on installment sales, which reduces the overall tax on the entire transaction, the federal government set a floor rate for **minimum interest reporting** on carryback notes. Minimum interest rates limit the extent to which taxes can be reduced, properly called *tax avoidance*.

Conceptually, all sums received by the seller on the carryback note, whether labeled as principal or interest, are subject to a **reallocation of principal to interest** under *imputed interest reporting* rules.

The **rules for imputing** only apply to the seller. The **buyer reports** the principal and the interest as agreed in the carryback note, and the terms of the note remain unaltered by any imputing reported by the seller.

Reallocation of principal to interest

Carryback financing arrangements are subject to the minimum imputed interest rate reporting rules if the terms of the note call for any payments to be due more than six months after the date the transaction closes.

Every debt that is the result of an extension of credit on a sale, such as a note carried back by a seller, has an **Applicable Federal Rate (AFR)** of interest. The note's AFR sets the minimum rate of interest the seller can report over the life of the carryback note. The rate of interest reported is fixed and does not vary during the life of the note, unless the terms of the note are modified.

Each carryback debt and security device, such as a trust deed note, land sales contract, lease-option sale or a lease-purchase agreement, has its own AFR. These security devices used by the seller include the terms for payment of the installment debt owed the seller for the unpaid portion of the purchase price.

Figure 1

Example Applicable Federal Rates

June 2008

Short term, not over 3 years:	**AFR**
Monthly	2.06%
Quarterly	2.06%
Semi-annual	2.07%
Annual	2.08%
Medium term, between 3 and 9 years:	**AFR**
Monthly	3.15%
Quarterly	3.16%
Semi-annual	3.17%
Annual	3.20%
Long term, over 9 years:	**AFR**
Monthly	4.37%
Quarterly	4.39%
Semi-annual	4.41%
Annual	4.46%

Any carryback debt negotiated at an interest rate lower than the note's AFR triggers the reporting of a portion of the note's principal balance as interest. AFR reporting entails an allocationand conversion of principal to interest by the taxpayer, called *imputing*. [Internal Revenue Code §1274(b)]

Taxwise, **imputing decreases** the amount of principal reported on the carryback note. In effect, imputing also reduces the sales price the seller reports for the property sold. Likewise, the **profit** which would have been reported without imputing is decreased. Further, the **interest income** is increased by the amount of principal allocated to interest. [See Figure 1]

The financial result of this shift of funds from profits to interest income is an overall increase in the amount of taxes the seller will pay on the transaction.

The buyer is completely unaffected by the imputing and the seller's income tax reporting.

Applicable Federal Rates

Figures for the Applicable Federal Rates (AFRs) are set monthly by the Internal Revenue Service (IRS). AFR figures are loosely based on the rates of return (yield) on Treasury notes and bills issued by the government.

The figure setting the AFR for a particular carryback note is selected based on three factors, including:

- the **acceptance date** of the purchase agreement;
- the **term of the note**; and
- the note's periodic **payment schedule**.

The first step towards identifying the proper AFR for a note is to locate the AFRs for the **month of acceptance** of the purchase agreement or counteroffer, lease-option or land sales contract. Alternatively, the AFR figure may be selected from the AFRs for either of the two months preceding the date the purchase agreement is accepted. [IRC §1274(d)(2)]

The IRS sets 12 fixed-rate AFRs each month. Thus, based on the **note's due date**, the fixed rates are broken down into **three AFR categories**: short-, medium-and long-term. Further, each category contains four rates, classified as monthly, quarterly, semi-annual and annual **periodic payment schedules**, one of which is selected based on the payment schedule in the carryback note. [See Figure 2]

The second step towards identifying the proper AFR for a note is to select the AFR category in which the note belongs, based on the **term of the note**. The selection of a category is set by the number of years from the closing of the sale to the due date of the note's final payment. The categories are divided as follows:

- notes with due dates of **three years or less** fall into the **short-term** AFR category;
- notes due between **three and nine years** fall into the **medium-term** AFR category; and
- notes due in **over nine years** fall into the **long- term** AFR category. [IRC §1274(d)(1)(A)]

Option periods to renew or extend the note's due date are included when figuring the length of the note's term and selecting the correct AFR category. [IRC §1274(d)(3)]

The last step towards identifying the proper AFR for a note is to select the rate within the due date category that matches the note's periodic **payment schedule** (monthly, quarterly, etc.).

9% ceiling up to threshold amount

For all carryback sales entered into in 2008, in an amount no greater than $4,913,400, called the interest threshold, the minimum reportable interest rate is the lesser of 9% or the note's Applicable Federal Rate (AFR). [Revenue Ruling 2008-3]

Thus, 9% compounded semi-annually is the **maximum rate** for imputing carryback notes with a principal balance at or below the threshold amount, even though the AFR may exceed 9% (as it did in the early 1980s). [IRC §1274; Rev. Rul. 2003-119]

The threshold amount for applying the 9% ceiling is **adjusted for inflation** each year by the Internal Revenue Service (IRS), starting from a base amount of $2,933,200 in 1990. [IRC §1274A(d)(2)]

A carryback note with a principal amount greater than the interest threshold must report interest at or above the note's AFR on the entire amount on the note, without regard to the ceiling of 9% and not just on the amount exceeding the threshold. In summary, if the note rate is less than the note's AFR, the principal amount of the note (for reporting only) is reduced to conform to the amortization schedule, due date and the note's AFR, a process which is called *imputing*. All carryback notes that are part of the same transaction or a series of **related transactions** are considered to have occurred in one sale. The amounts to be paid in principal and interest over the life of all carryback notes in related sales transactions are totaled to determine whether the 9% threshold ceiling or the AFR restrictions apply. [IRC §1274A(d)(1)]

Reamortize and report to impute

The Internal Revenue Service (IRS), in pursuit of a higher tax revenue, introduces an equalizer in the form of a minimum annual **rate of interest** the seller will report on a carryback note. This floor rate for reporting interest income neutralizes the seller's ability to effectively raise the price a buyer will pay in exchange for reducing the interest charges on the carryback note. Thus, the minimum reportable interest rate implicitly affects the maximum sales price of property.

Now consider a seller who agrees in a purchase agreement to carry a note for $100,000 at an interest rate of 7%, payable $665.30 monthly with a $94,131.77 final/balloon payment due in five years. Based on the month the purchase agreement is entered into by all parties, the carryback note's medium-term due date and the monthly principal and interest payment schedule, the fixed Applicable Federal Rate (AFR) which controls for the entire life of the note is 8%, a higher rate than the 7% note rate.

Over the life of the note, the seller is scheduled to receive a total stream of principal and interest payments equal to $134,049.59 — $100,000 in principal and just over $34,000 in interest under the terms of the 7% note.

Each year, the seller will receive principal and interest payments of $7,983.63 which he must first apply to and report as interest at no less than the note's AFR. The amount of the remaining payment is then deducted from the note's principal balance. The principal received is further broken down into basis and profit on the profit-to-equity ratio for installment sale reporting of profit taxable from year to year. [IRC §453]

Taxwise, the interest rate the buyer is charged is less than the AFR. Thus, interest income is imputed at the AFR figure for the seller's tax reporting. To **calculate the interest** income reported to the IRS, the seller must reamortize the note (based on the amount of the scheduled installments, the final/balloon payment amount and the numbers of months until due) at 8%, which is the note's AFR. These figures will set the amount imputed as interest which in turn reduces the principal amount reported on the note.

Figure 2

Remortization of imputed interest

- ✓ $1,000,000 note at 7% annual interest rate, AFR is 8%
- ✓ $665.30 monthly payments
- ✓ five-year due date
- ✓ Total payments collected equal $134,049.59; $7,983.63 annually in the first years plus $94,131.59 final payment

Principle reduction

Term	7% note balance	8% AFR balance
Origination	$100,000	$95,994
End of year 1	98,984	95,678
Year 2	97, 895	95,377
Year 3	96,727	94,966
Year 4	95,475	94,566
Final payoff	**94,131.59**	**94,131.59**

This re-analysis of the principal and interest in the note's stream of scheduled installments and payoff amounts at the imputed interest rate **reduces the profit** by reducing the original principal amount of the note and the principal amount contained in each payment. Conversely, a larger portion of each payment than originally agreed to in the note is reported as interest income. [See Figure 1]

Commingling interest and profit

Profits reported on the sale of real estate are taxed at rates ranging from 10% to 25% for various types of *gains* on real estate sales.

Ordinary income is taxed at higher rates than profits, ranging from 10% up to 35%, which sets the rates for taxes paid on interest income.

The objective of imputed interest reporting is to prevent carryback sellers from structuring the price and terms of payment to convert interest income into profit (**gains**) and achieve up to a 60% reduction in taxes on the amount converted to profits over the life of the note.

For example, a carryback seller of rental property compensates for his increased sales price by negotiating a reduced interest rate on his carryback note. The result is a zero-sum difference in the amount of dollars he will receive over the life of the note.

The remaining rentals he owns are highly leveraged and produce annual operating losses. The interest income received on the carryback note will not directly offset the rental operating losses (since it is portfolio category income, not passive rental category income). However, if he is classified as being in a real estate related business, he can offset the interest income by the rental losses.

Taxwise, the high sales price generates excessive profits as principal payments are received from year to year on the note. Thus, the large annual reportable operating losses from the seller's highly leveraged rental properties will annually offset the excess profit from the installment sale of a rental which will be reported each year in the passive income category. Unless the seller can write off the operating losses as resulting from real-estate-related business, the losses will not offset interest income since interest is reported in a separate income category.

The seller will use his annual reportable rental operating losses to shelter his artificial profit received annually on the installment sale of the rental property at an above market price.

The monthly payments received by the seller equals the same amount he would receive in monthly payments on a lesser purchase price with a higher interest rate.

Here, compulsory reporting of imputed interest at minimum rates prevents sellers who are not in a real-estate-related business from commingling investment category interest income with rental category operating losses to offset one another and neutralize taxes. [IRC §469(c), (e)]

Interestingly, no reporting rules exist to govern the opposite process by which the seller reduces the purchase price and, by the terms of the carryback note, converts profit into increased interest earnings. This process would increase portfolio category income (in order to, for example, eat up losses carried forward on stock sales and carrying costs of land ownership).

Consider a "land-poor" seller who has built up substantial investment/portfolio category losses carrying his property. The seller sells his rental category property (with a $1,000,000 fair market value) in the passive income category for $750,000 with a $100,000 down payment.

The seller carries back the balance in an all- inclusive note (AITD) for $650,000 at 15% — significantly above current market interest rates — with a seven year due date. To ensure his high yield for seven years on the note will effectively recover the dollar amount of the $250,000 price reduction, the seller includes a lock-in clause in the note which bars prepayment for seven years. In case the note is legally payable at any time during the seven year period, a stiff prepayment penalty of 30% on unscheduled principal payments is included to cover the shortfall in total receipts from the sale (interest for seven years) due to an early payoff.

Thus, the seller has effectively converted $250,000 of his profit on the sale of rental property into investment category interest income on the carryback note. A portion of his actual rental profit (converted to interest) is now sheltered by his accumulated investment/portfolio losses carried forward from prior years due to land ownership expenses (or stock market losses).

Threshold for accrual reporting

If the principal amount of a carryback note is more than $4,913,400 for 2008, labeled the *accrual threshold*, the seller must report interest income each year **as the interest accrues** without regard for when the payments are received. [Rev. Rul. 2008-3]

For example, a carryback note with a principal amount of $5,000,000 calls for a **graduated interest rate** of:

- 5% the first year;
- 6% the second;
- 7% the third;
- 8% the fourth;

- 9% the fifth; and

10% in years six through eight with a **final/balloon payment** due on the eighth anniversary of closing.

The amortization period for the payments is 30 years, with principal and interest payable monthly. Each year the amount of the payment increases as the note is reamortized at that year's graduated rate for the remainder of the amortization period.

To determine if additional interest income will be imputed, one must first establish the **average annual interest** charged during the eight-year term of the note. To do so, interest on the accrual basis must be calculated as a constant (average) annual yield over the eight-year term, taking into account all interest agreed to be paid on the note in the future.

The average yield is 7.75% over the eight-year life of the note. Since accrual-threshold notes, such as the $5,000,000 note, are controlled by **accrual reporting**, the carryback seller reports interest annually at the note's constant **average yield** (in this case 7.75%) over the full term of the note. In the graduated payment example, this leads the seller to report more interest income than he actually receives in the early years of the note, and less interest income than he actually receives in the later years under the terms of the note.

Additionally, if the average yield on the accrual- reporting note is less than the note's Applicable Federal Rate (AFR), the seller must report interest at the AFR each year.

The straight note will awaken

The fundamental difference between annual accrual reporting and cash reporting is best demonstrated by considering a carryback note with principal and interest due in one installment payable after the year of sale, sometimes called a *straight note* or *sleeper trust deed*.

First consider a carryback note for $1,000,000, at 5% interest compounded annually, with principal and interest due in two years. The note's short-term Applicable Federal Rate (AFR) is 7%, compounded semi-annually.

In this example, the seller is entitled to report his profit and interest income from the **straight note** on the **cash method** when he receives the principal. The straight note does not exceed the threshold amount which would require accrual accounting rather than cash accounting. A statement is filed with the seller's tax return in the year of the sale which states that no interest will be reported until the loan is paid in full. [Revenue Regulations §1.1274A-1]

The seller receives $1,102,500 of principal and interest in a final/balloon payment on the due date of the straight note. However, rather than reporting the 5% interest income of $102,500 as stated in the note, the seller must report the interest at the note's AFR.

Thus, he will report $140,000 (rather than $102,500) as interest income. The remaining $962,500 of the payment (rather than $1,000,000) is principal which represents profit and a return of capital in amounts based on the equity-to-profit ratio for the original installment sale transaction. [See Chapter 22]

Now consider a carryback **sleeper trust deed** note for $10,000,000, a principal amount that exceeds the accrual threshold and requires annual (accrual) reporting of interest.

The $10,000,000 sleeper trust deed note calls for 5% interest, compounded annually, with a two-year due date for the payment of all principal and interest. The note's short-term AFR is 7%, compounded semi-annually.

The principal amount of the note is first recomputed to impute interest at the note's AFR. Once the principal amount is recomputed, the seller's reportable principal in the note is no longer $10,000,000, but slightly over $9,600,000. Thus, like cash reporting, accrual reporting includes additional interest income of approximately $400,000 **imputed as interest** over the two year period, which reduces the note's principal amount (and profit on the sale).

However, unlike cash reporting, accrual reporting requires interest to be reported annually at the note's AFR, as it **accrues unpaid**.

As a result, nearly $700,000 is reported as portfolio category interest income in the first year, even though the seller receives no payment with which to pay the taxes on the accrued interest income.

Special imputed interest rates and exemptions

Interest on **sale-leaseback financing** arrangements is imputed at 110% of the note's Applicable Federal Rate (AFR). [IRC §1274(e)]

Carryback notes created on the sale of land between **family members** will impute interest at a ceiling rate of no more than 6%, compounded semi-annually, unless the total sales price of all transactions between the same two family members in the same year exceeds $500,000 (the threshold which triggers imputed interest reporting at the note's AFR). [IRC §483(e)]

The following carryback notes are exempt from imputed interest reporting:

- carryback notes with a due date of six months or less [IRC §1274(c)(1)(B)]; and
- notes with a principal amount less than $3,000. [IRC §483(d)(2)]

A carryback note assumed by a buyer does not receive a new AFR at the time of assumption, unless the terms of the note are modified. [IRC §1274(c)(4)]

Chapter 22 Seller financing diminishes tax impact

This chapter illustrates the favorable impact installment sale tax reporting has on a carryback seller who finances the sale of his real estate.

Installment sale defers profit reporting

A seller lists his property for sale with his real estate agent. The listing price for the property is $1,500,000 and it is free of encumbrances. The seller's *cost basis* in the property is $100,000.

The seller's goal is to convert his ownership of the real estate into a relatively management-free, interest-bearing investment. The seller is a lifetime investor and is not inclined to turn his real estate over to a trustee or exchange it for an unsecured annuity.

Consistent with his management-free investment goals, the seller is willing to carry back an interest-bearing installment note to provide financing for a buyer. The monthly payments on the note includes interest which will provide the seller with an income, replacing the **net operating income** (NOI) he currently relies on from the property.

The seller's broker locates a buyer for the property. A full listing offer is made consisting of:

- a 20% down payment; and
- a note payable to the seller for the 80% remainder of the purchase price.

The buyer will tender a $300,000 down payment in cash and execute a note in favor of the seller for the balance of the price, secured by a trust deed on the property. The transaction will close prior to the end of the year. The first installment of the carryback note will be paid in the year following the year of the sale.

The terms of the note carried back by the seller will include:

- $1,200,000 in principal;
- 7% interest;
- monthly payments of $7,983.63 on a 30- year amortization; and
- a 10-year due date for a final balloon payment of $1,029,748.

The listing agent reviews a cost analysis of the sale with the seller, noting the net sales price after payment of around $100,000 in closing costs will be approximately $1,400,000. Then, taking the seller's cost basis of $100,000 into account, the listing agent calculates the profit the seller will realize on the sale to be approximately $1,300,000.

When will the seller have to pay taxes on the $1,300,000 in profit taken on the sale of his property?

The seller will **automatically report** the sale as an *installment sale* on his income tax return. The reporting will **defer payment** of a significant amount of profit taxes to later years when installments on the carryback note are received. The portion of the installment which is principal, represents in part the profit received after the year of sale. [Internal Revenue Code §453]

Deferring the tax on profit

For a seller of real estate, *profit* is the portion of the net sales price remaining after deducting the seller's remaining capital investment (**cost basis**) in the property. The formula is: net price minus basis equals profit. However, a developer's dealer property, such as lots or homes sold by a developer, generates ordinary income, not profit.

When a sale of real estate generates profit, called *gain* by the Internal Revenue Service (IRS), **all profit** taken on the sale is reported in the year of sale, unless the profit is:

- *excluded*, which occurs when the sale of property qualifies as a principal residence for the Internal Revenue Code (IRC) §121 $250,000 profit exclusion per individual home owner;
- *exempt*, which occurs on the sale of business or investment property when the net sales proceeds are used to acquire identified replacement property in an IRC §1031 reinvestment plan, or to replace property taken by eminent domain; or
- *deferred*, which occurs when the profit on a sale is allocated to a note carried back on the sale and reported under the IRC §453 installment method.

Applying the profit-to-equity ratio

Before reporting the profit realized on a sale, the **profit is allocated** between the cash proceeds received from the sale and the carryback note.

To accomplish the allocation, a ratio is established between the **profit and the net sale proceeds** from the seller's equity. The percentage of the net sales proceeds which represents profit on the sale sets the ratio, called the *contract ratio* by the Internal Revenue Service (IRS), or the *profit- to-equity ratio*. Thus, whatever percent of the net equity is profit sets the **profit-to-equity ratio** applied to the cash and carryback note received from the sale.

Continuing with our previous example, the **net proceeds** from the seller's equity in the property are $1,400,000, the sales price ($1,500,000) minus any debt relief ($0), minus closing costs ($100,000).

Thus, the percentage of the $1,400,000 **net sales proceeds** represented by the $1,300,000 in profit is 93% (rounded up from .928571), the **contract ratio** or **profit-to-equity ratio**.

Accordingly, 93% of the net cash proceeds received on closing ($200,000) is reported and taxed as **profit** ($185,720) in the year of the sale. In future years, 93% of the principal in each installment paid on the carryback note and received during the year is reported as profit.

Thus, $14,280 of the cash proceeds from the down payment represents the seller's recovery of a portion of his remaining **cost basis** in the property and is not reported as taxable profit, it is a tax-free return of his invested capital.

Each monthly installment on the seller's $1,200,000 carryback note is $7,983.63.

During the year following the year of sale, the 12 installments received by the seller will include $12,189.72 in principal plus $81,613.84 in interest. Additional interest is also paid to the seller to cover any interest that accrued unpaid in the year of the sale.

The seller will report all the interest received as **portfolio category income** without regard for whether the profit is business category or passive category income.

For profit reporting, the profit-to-equity ratio of 93% is applied to the principal in each installment received on the note. Thus, the carryback seller's reportable profit in the first year (following the year of sale) is $11,319.37, 93% of the $12,189.72 in principal payments the seller will receive.

The 7% remainder of the principal he will receive is untaxed — $870.35 — since it represents a partial return of the seller's original capital investment (remaining cost basis).

Ultimately, the final/balloon payment will be received by the seller. Again, the profit-to-equity ratio of 93% will be applied to the final principal payment of $1,029,748.66 ten years after closing. The profit reported by the carryback seller when the final/balloon payment is received will be $956,224.55, 93% of the principal in the balloon payment.

Since the seller acquired the property as a depreciable long-term investment (capital asset) and actually held the property for at least one reporting period, the profit taken by the seller consists of two types of gains:

- *unrecaptured gain* in the amount of all depreciation taken during the seller's ownership (and taxed at a 25% rate); and
- *long-term gain* in the amount of all remaining inflation-appreciation profit (and taxed at a 15% rate).

The goals in an installment sale

While a carryback seller will pay a profit tax on all of the profit in a down payment, final/balloon payment and principal installments, the seller achieves two financial goals on the installment sale of his real estate:

- the **highest sales price** possible by providing the buyer with financing to facilitate the sale; and
- the **maximum annual income** by earning interest on the principal in the carryback note, principal which includes unpaid and deferred profit taxes on 85% of the sale.

When the seller carries back a *straight note* calling for all the principal to be paid in a final/balloon payment after the year of sale, the sale is also reported as an *installment sale*. Here, the one installment is scheduled to be received after the year of the sale. [IRC §453(b)(1)]

However, a **straight note** due in the year of the sale, but paid delinquently, does not qualify the transaction for **installment sale reporting**.

The seller may structure payments on the carryback note so he will receive all or most of his principal (and thus **profit**) in a designated later year (or in any year on demand), if he anticipates taking a substantial loss in that later year which will offset reportable profit on the principal in his carryback note.

Debt relief, profit and taxes

Consider a seller who is solicited by an agent to list his investment real estate for sale. The seller recently refinanced the property, encumbering it with a note which has a principal balance of $480,000.

Sales terms the seller is willing to accept for the sale of the property include:

- a purchase price of $800,000;
- a 20% down payment of $160,000;
- an assumption of the existing $480,000 trust deed loan by the buyer; and
- a carryback note for the balance of the seller's equity, $160,000.

In a discussion with the seller about his profit on the sale, the agent determines the seller's **remaining cost basis** in the property is $50,000, the improvements having been fully depreciated since the seller's purchase of the property in 1985.

On a sale of the property for $800,000, the *net sales price* will be approximately $720,000 after deducting all transactional costs.

The **net sales price**, besides representing the seller's debt and equity, is a return of his $50,000 remaining cost basis and a $670,000 profit on the sale. The profit is a result of depreciation deductions (*unrecaptured gain*) and an increase in the property's dollar value due to inflation and local appreciation (*long-term gain*) during the seller's years of ownership.

All of the **profit** on the sale, unless deferred, exempt or excluded from taxation, will be taxed in the year of sale as either **unrecaptured gain** (depreciation) at a rate of 25%, or as a **long-term capital gain** (increased value) at the current rate of 15%. The federal income tax bill will require around $125,000 to be paid from the net proceeds of the sale plus tax to the state of California, all totaling nearly 25% of the net sale proceeds.

Although the seller does not want to remain responsible for payments on the existing loan, the listing agent suggests the seller reconsider his requirement that a buyer must assume or refinance the existing loan.

The agent explains to the seller how an **assumption or refinancing** of his existing loan by the buyer on an installment sale would produce an adverse tax consequence.

Existing financing as profit

The calculation of profit on a sale is unaffected by the existence or nonexistence of mortgage debt. Debt encumbering a property plays no role in calculating the profit on a sale.

However, the assumption or refinancing of an existing debt by a buyer in a carryback sales transaction plays a huge role in setting the percentage of the down payment and principal in the carryback note which will be reported as profit and taxed each year as payments are received. The *percentage* is the portion of the seller's **net proceeds** from the sale — cash and paper — which is profit on the sale, the profit-to-equity ratio.

Taxwise, the seller's goal in an installment sale is to structure the net sales proceeds (cash and paper) to produce the **lowest profit-to-equity ratio** possible. The lowest percentage possible in any sale is achieved when the net sales price and the net sales proceeds are the same, as in our opening scenario for this chapter. This percentage occurs naturally when the property is free of debt, unencumbered by liens. Stated another way, there is *no debt relief* on the installment sale.

For the seller to receive the maximum tax deferral benefits available on an installment sale, **no debt relief** can occur. To entirely avoid debt relief when the property sold is encumbered by a trust deed, the seller must **remain responsible** for the trust deed debt after closing the sale. An all-inclusive trust deed (AITD) carryback or land sales contract accomplishes this debt relief avoidance as an installment sale of property since the buyer does not assume or refinance the seller's existing loan.

Here, the principal amount of the carryback note is the balance due on the **purchase price** after deducting the down payment (as occurs with an AITD note), not for the balance of the equity above the down payment (as occurs with a regular trust deed note and a loan assumption or refinance by the buyer).

For example, the greater the amount of the debt assumed (or paid off on the sale) by the buyer, the smaller the seller's net sales proceeds. The profit on the sale does not vary, regardless of how the sale is financed. Thus, the smaller the seller's net proceeds on the sale (cash and carryback note), the higher the percentage of the profit attributable to the net sales proceeds.

When the amount of the mortgage debt assumed or refinanced by the buyer exceeds the seller's remaining cost basis, the amount of the seller's profit will be greater than the seller's net sales proceeds, a situation called *mortgage over basis*. Thus, all principal received on closing the transaction or by installment payments will be profit, and the profit-to-equity ratio will top out the note as 100% profit. [Revenue Regulations §15A.453-1(b)(2)(iii)]

Loan assumption or an AITD

In our previous loan assumption example, 100% of the net proceeds from the down payment and all the principal in the seller's $160,000 carryback note will be profit, taxable in the years the principal amounts are received by the seller. As always, the tax is deferred only on that portion of the $670,000 profit allocated to the principal in the carryback note ($160,000). On the assumption of a loan by a buyer, the amount of the carryback note is a small portion of the total sales price.

The remaining $510,000 in profit not allocated to the carryback note is taxed in the year of sale. Thus, the 25% and 15% profit tax due to the Internal Revenue Service (IRS) on gains (unrecaptured and long-term) in the year the property is sold would be around $105,000 (plus state taxes).

However, the seller's cash sales proceeds are only $80,000, the $160,000 down payment minus the $80,000 in closing costs.

If the carryback seller allows a buyer to assume the existing debt, the immediate financial result will be disastrous since taxes will greatly exceed the seller's cash proceeds. The seller's only relief on an assumption and carryback sale will come from any substantial losses he may incur from other business or investment sources which will offset these profits, and thus reduce his tax liability.

A far more prudent approach exists. The seller can structure the carryback note on the sale of encumbered property as an all- inclusive trust deed (AITD) note for the balance of the purchase price, not just the amount of equity remaining unpaid after the down payment and assumption of the existing loan. With an AITD note, the total amount of the cash down payment and AITD note will equal the *net sales price*, making the AITD note a substantial 80% portion of the sales price. The resulting profit- to-equity ratio will be the lowest percentage figure available for allocation of profit between the cash proceeds and the carryback note.

AITD usage defers more taxes

A broker needs to be able to explain to a seller of encumbered property how the carryback of an all-inclusive trust deed (AITD), also called a *wraparound security device*, will:

- reduce the amount of profit allocated to the down payment (and thus reduce the seller's profit taxes in the year of sale); and
- increase the amount of profit allocated to the carryback note (and thus defer to future years the payment of taxes on **all profit** not allocated to the down payment). [See Figure 1]

A necessary arrangement for the seller on the sale of encumbered property is to retain responsibility for all future payments on the trust deed note in order to **avoid debt relief**. To retain responsibility for the loan, the seller must carry back an AITD (or land sales contract) for the **balance of the purchase price** remaining unpaid after the down payment, not a regular note for the balance of his equity after the down payment. Thus, the seller will continue to make payments on the existing loan.

A seller who will remain responsible for a wrapped loan that contains a due-on clause should obtain the **lender's consent** to the carryback sale, called a *reverse assumption*, since the buyer **will not assume** the loan.

The seller may be required to pay an exaction (points and loan modification) to induce the lender to waive the due-on clause and consent to the transfer of title and further encumbrance with the AITD.

Other types of **wraparound financing devices** produce the same tax results as an AITD note. Examples include: land sales contracts, contracts for deed, lease-option sales, and lease- purchase sales agreements. These alternative financing devices also trigger the due-on clause in any trust deed of record (and reassessment for property taxes), as does any carryback note secured by a trust deed on an encumbered property.

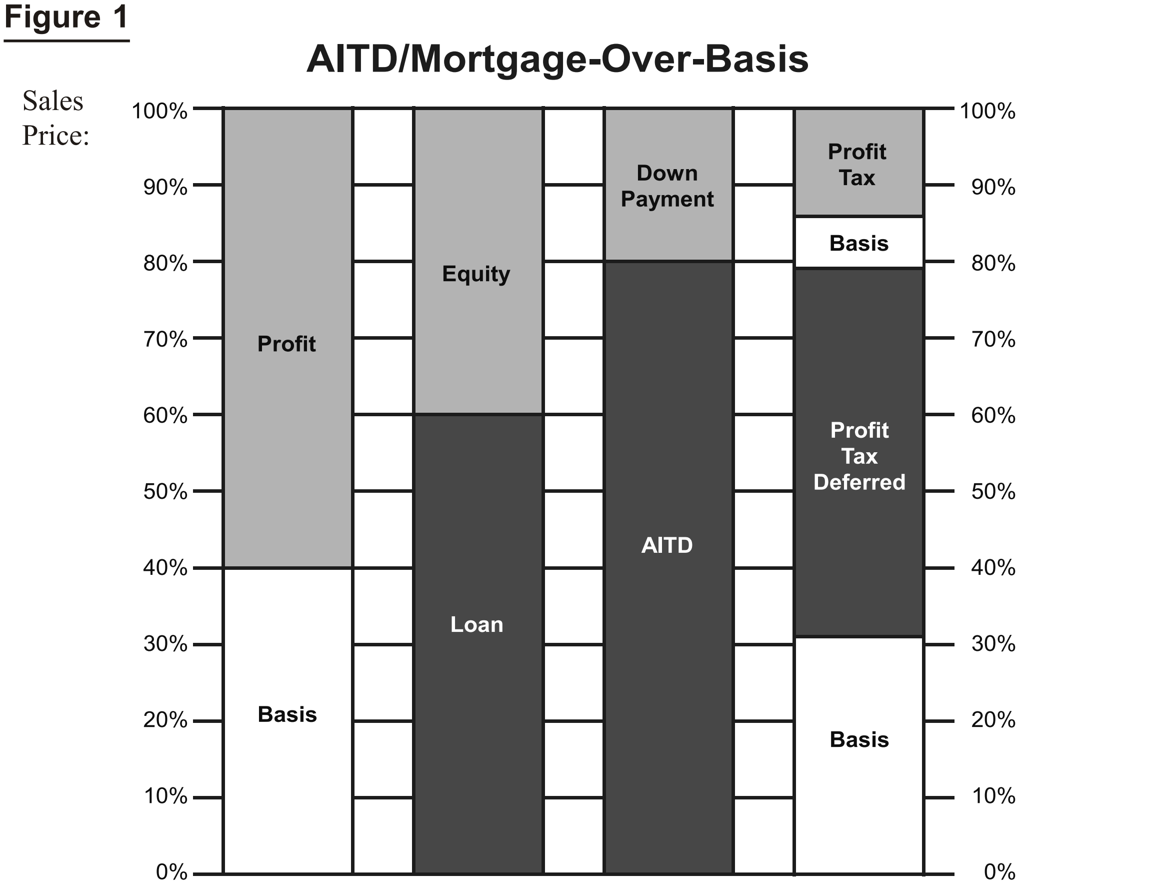
The profit allocated to the AITD note will be sheltered from the payment of profit tax until the seller:

- receives payments of principal on the AITD note;
- hypothecates (pledges) the AITD note; or
- shifts the responsibility for payment of the underlying wrapped loan to the buyer. [**Professional Equities, Inc.** v. **Commissioner** (1987) 89 TC 165]

Continuing with our previous example, the seller's **net sales proceeds** of $720,000 (cash plus the AITD carryback) are the same as the seller's **net sales price** when the seller remains responsible for the existing loan under an AITD carryback.

Since the profit on the sale is $670,000 and the net sales proceeds are $720,000, the profit-to-equity ratio will be 93%, the lowest percentage available on this sales transaction.

Figure 1



In the year of sale, the seller will net $80,000 from the down payment, of which 93% ($74,400) is reportable as profit. All other profit has been allocated to the principal amount of the AITD note. Thus, taxes on all profit not allocated to the down payment are deferred to later years.

The 25% tax on gains from unrecaptured depreciation represented by the $74,400 profit allocated to the down payment is around $18,600. The use of the AITD avoids the $105,000 in taxes the seller would have incurred in the year of sale (as shown before) had the buyer assumed or refinanced the seller's existing loan.

Structuring the carryback sale as an AITD allows the seller to receive **after-tax sales proceeds** of $61,400 from the $80,000 net down payment.

In conclusion, the 93% profit-to-equity ratio will be applied to the principal received in the AITD payments and on the final payoff. The profit-to-equity ratio sets the amount of the profit in the principal on the note which will be taxed when the principal is paid.

AITD later modified to take the profit

Consider a seller who carried back an all-inclusive trust deed (AITD) note on the sale of rental property in a prior tax year. Profit from the sale was allocated to the AITD note, reported and taxed on the installment method.

In the current tax year, the seller sustains either a substantial trade or business loss, or an operating or capital loss in the rental (passive) income category. A portfolio loss on stocks or bonds does not offset the profit taken on a rental property in the passive income category, except for $3,000 annually.

The seller takes no profits this year to offset his loss. The losses, be they business or rental, are of no further tax benefit after the current year since the seller is treated as being in a real estate related business.

However, the seller can shift a portion of the profit from the AITD note into the current year **by negotiating a modification** of the AITD with the buyer. With a modification, the seller can arrange to report a substantial portion of the installment profit in the current year by:

- **shifting responsibility** for the wrapped loan to the buyer by allowing him to assume or refinance the wrapped loan;
- **reducing the principal** balance in the AITD note by the amount of the loan assumed or refinanced by the buyer; or
- **pledge the AITD note as collateral** for a loan of an amount equal to his losses.

The percentage of profit in the principal of the AITD note, as set by the profit-to-equity ratio, is applied to the principal reduction on the AITD note — a reduction equal in amount to the loan assumed or refinanced, or the pledge of the note — to determine the amount of profit to be reported due to the debt relief.

Thus, by **incurring debt relief** by renegotiating the terms of the AITD note and converting it to a regular note, the carryback seller is able to engineer the time for reporting a substantial amount of the profit in his carryback. As a result, the tax on the profit is avoided by the offset provided by the losses from business or rental category operations and sales in the year the AITD is modified.

Pledging carrybacks

A seller who **pledges** his carryback note as collateral for a loan, called *hypothecation*, triggers the reporting of a portion of the profit which was allocated to principal in an amount equal to the amount

Broker Considerations

When assisting a seller in a carryback sale, the broker should be aware of other tax factors including:

- the **$5 million carryback threshold rule** — a seller who carries back more than $5 million in paper during any one tax year will incur an interest charge on the amount of the deferred tax [IRC §453A];
- **accrual accounting threshold** — if the carryback amount in 2008 is $3,509,600 or more, the seller must use the accrual method of accounting, reporting interest income as it accrues, whether or not payment of interest is actually received [IRC §1274A(c)(2)(A); Rev. Rul. 97-56]; and
- **minimum interest reporting** — if the carryback amount in 2008 is up to $4,913,400, the interest rate charged must be no less than 9% or the applicable federal rate (AFR). [IRC §1274A(b); Rev. Rul. 97-56]

If the interest charged on the carryback note is lower than the AFR, the seller must report interest at the AFR rate, called *imputing,* reducing the amount of principal, and thus profit, on the note. [IRC §1274(b)(1)]

borrowed. The borrowing and pledging can also be timed to occur in a tax year when a loss on a business or rental activity has occurred, thus offsetting one another.

When a seller pledges a carryback note, the **loan proceeds** are considered to be equivalent to the payment of principal on the note. Thus, profit allocated to the principal is reported and taxed in an amount equal to the loan amount. [IRC §453A(d)(1)]

The percentage under the profit-to-equity ratio, used to allocate profit to the carryback note, is applied to the amount of the loan proceeds to determine the amount of profit to be taxed due to the pledge. [IRC §453A(d)(2)]

Prepayment penalties

On the prepayment of a carryback note, the principal paid to satisfy the note includes profit which is reported and taxed in the year of the premature payoff. [IRC §453(c)]

To assure a seller he will retain his tax advantages of an installment sale until the final/balloon payment becomes due, the listing agent will suggest his client include a *prepayment penalty* clause in the carryback note.

*Editor's note — Statutory limits exist for **prepayment penalties** on carryback notes secured by owner-occupied, one-to-four unit residential properties. [Calif. Civil Code §2954.9]*

However, for all other types of property, a prepayment penalty clause may be structured to compensate the seller for the entire amount of the projected profit tax he would prematurely incur due to the prepayment of principal on the note.

The prepayment penalty must be reasonably related to the actual expenditures likely to be made for the payment of profit taxes on a buyer's early payoff, including:

- **profit taxes**, based on current or reasonably anticipated rates; and
- **maintaining a portfolio yield** during the lag time after early payoff and before the funds are re-invested.

Election out

A seller may elect out of installment sale reporting by voluntarily reporting the profit as taxable in the year of the sale. [IRC §§453(a), 453(d)(1)]

Reporting all the profit on a carryback sale as taxable in the year the property was sold (and escrow was closed) may be advantageous to a seller who during the year of sale has an equivalent offsetting factor such as:

- *trade* or *business loss*, on a real estate brokerage or development business;
- *rental operating loss*, directly offset by the profit on a carryback sale of a rental property;
- *rental operating losses* which reduces the seller's adjusted gross income (AGI) if he is in a *real-estate-related business* activity;
- *capital loss* on the sale of a rental or passive business investment; or
- *capital loss* carried forward or from the sale of investment/portfolio category assets (stocks and bonds) when the installment sale is of an investment/portfolio category property, such as the sale of land held for profit on resale, a second home or a triple-net leased, management-free rental property.

California FTB installment sale rules

Unlike the federal withholding scheme, California requires the buyer, through escrow, to withhold 3⅓% of the sales price from the seller's proceeds on all sales, unless the transaction is excluded from withholding. **Excluded transactions** include sales by all California-based entities and by any individual who **certifies** that the transaction qualifies for an exclusion from withholding for the Franchise Tax Board (FTB).

For individual sellers entering into an installment sale of their property, the transaction is either:

- *qualified* from withholding by the individual seller certifying it is excluded; or
- *not qualified* and subject to the mandatory withholding of the entire 3⅓% of the price from the down payment, unless the **buyer agrees to withhold** the 3⅓% from each installment of principal paid on the price. [See Franchise Tax Board Form 593I]

If the buyer refuses to withhold and forward 3⅓% of the principal in each periodic payment to FTB, the carryback note may call for installments of interest-only payments and avoid amortization of the principal. Thus, only the final/balloon payment would contain a payment of principal. In this fashion, the buyer's agreement to withhold principal would be limited to the final payoff. Then, the buyer would only be responsible for one filing with the FTB, besides the original filing by escrow which withheld 3⅓% of the cash proceeds from the down payment, not 3⅓% of the sales price.

However, the sale may **qualify for exclusion** from California FTB withholding. If the sale is excluded, the issue of buyer cooperation to withhold on every payment of principal is eliminated.

The seller's **transaction is excluded** from FTB withholding on both the down payment and the dollar amount of a carryback note, if:

- the property is the seller's **principal residence**;
- the sale is declared by the seller to be a **Internal Revenue Code (IRC) §1031 reinvestment transaction** (with the carryback note being payable to the buyer's trustee for ultimate assignment as consideration for the purchase of a replacement property);
- the property is **sold at a loss** if the purchase price is less than the remaining cost basis; or
- the property is sold for a **price of $100,000** or less.

Miscellaneous installment rules

A carryback note must qualify for installment sale reporting at the time escrow closes. The seller may not restructure a carryback transaction **after escrow closes** in an attempt to qualify the sale as an installment sale by extending the due date on the carryback note from the year of sale to a date beyond the year of the sale. [Revenue Ruling 56-20]

However, the seller may later restructure a carryback note he has reported as an installment sale by modifying its terms, such as extending its due date, subordinating the trust deed to a new trust deed loan, or accepting substitute security from the buyer.

For builders and developers who sell their *dealer property* on a credit sale, installment sale reporting is not available (with exceptions). Their earnings from the sale of inventory are trade/business income, not profit taken on the sale of a capital asset or property actually used to house or conduct the ongoing trade or business operation. [IRC §453(b)(2)(A)]

However, the **dealer property** exclusion does not apply to the installment sale of farms, vacant residential lots and short-term timeshares, even though they may be classified as dealer property. [IRC §453(I)]

No stepped-up basis on death

Consider a wife who, on her husband's death, becomes the owner of her husband's one-half interest in a carryback note they jointly held from an installment sale in a prior tax year. The note was previously carried back on the sale of community property. The carryback note has been reported and taxed on the installment method, thus, the principal of the note contains untaxed profit.

The wife seeks a **stepped-up basis** on the entire note to its market value on the date of her husband's death since the note is a community property asset which she received on her husband's death.

In this scenario, the carryback note held by the community and received by the wife on her husband's death does not qualify for a step-up in basis. The note at the time of death contained profit which had been **realized** on a prior sale and was yet to be taxed as **recognized**. [**Holt** v. **United States** (1997) 39 Fed. Cl. 525]